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THE OFHEO REPORT: ALLEGATIONS OF ACCOUNTING AND MANAGEMENT FAILURE AT FANNIE MAE

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

OCTOBER 6, 2004

Printed for the use of the Committee on Financial Services

Serial No. 108–115

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THE OFHEO REPORT: ALLEGATIONS OF ACCOUNTING AND MANAGEMENT FAILURE AT FANNIE MAE

Wednesday, October 6, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:03 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Shays, Gillmor, Bachus, Castle, Lucas of Oklahoma, Royce, Manzullo, Kelly, Ney, Fossella, Biggert, Miller of California, Toomey, Capito, Hart, Kennedy, Tiberi, Brown-Waite, Kanjorski, Sherman, Meeks, Inslee, Capuano, Ford, Hinojosa, Lucas of Kentucky, Crowley, Clay, McCarthy, Baca, Matheson, Lynch, Miller of North Carolina, Scott, and Velazquez.

Also present: Representatives Oxley (ex officio), Frank (ex officio), Watt, Waters, Davis of Alabama, Maloney, and Brown of Florida.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order.

The Capital Markets Subcommittee meets today for the purpose of receipt of a report from the Office of Federal Housing Enterprise Oversight.

It is indeed a very troubling report, but it is a report of extraordinary importance not only to those who wish to own a home, but also as to the taxpayers of this country who would pay the cost of the cleanup of an enterprise failure.

Although not intended to fuel the effort to bring about regulatory reform, the analysis makes clear that more resources must be brought to bear to ensure the highest standards of conduct are not only required, but more importantly, they are actually met.

For the record, I am not pleased and certainly not happy about these revelations. I am saddened by the disclosures. In all my years of inquiry in this matter, I was only in pursuit of appropriate oversight. Never did I question whether the GSEs were professionally managed to the highest standards of business conduct. Now I do. The culture of mismanagement described in the report must be eliminated and assurances gained that the highest standards of conduct will be consistently practiced.

I know there will be those who will still cling to the belief that the issues raised are minor or that opinions may differ on technical accounting standards. Some may still think this is all a plot by the big banks to preserve market share. The content of this report, in my view, cannot be legitimately questioned. Utilizing the firm of Deloitte & Touche and the staff of OFHEO, the director's report is delivered after review of over 200,000 documents and e-mails, as well as hundreds of interviews and depositions of current and former staff of Fannie Mae.

The statement made in the first page of the executive summary unfortunately sums up our circumstance: "The matters detailed in this report are serious and raise concerns regarding the validity of previously reported financial results, the adequacy of regulatory capital, the quality of managerial supervision and the overall safety and soundness of the enterprise." This finding, in my judgment, makes committee action essential.

For the record, I should also note that the resistance the GSEs have expressed toward enhanced housing goals. In light of these revelations, their opposition now makes more sense than ever. Should the proposals considered in this committee focus clearly on the needs of first-time homebuyers actually become law, the enterprises would have to allocate resources to those goals at the expense of reduced earnings.

A reduction in earnings would reduce the likelihood of paying out bonuses to executives. This same observation holds true as to the regulator's decision to increase capital, and Fannie's strong objections to such a requirement. We all know that the enterprise is thinly capitalized, but the potential effect of requiring a responsible capital level would adversely affect earnings per share, and consequently affect the bonus payments to executives.

I also wish to inform members of the committee of another troubling incident, which I now choose to make public. About a year ago, I corresponded with the director's office making inquiry about the levels of executive compensation at the enterprise for the top 20 executives. This is information that had not been made public previously.

In a matter of days, Fannie Mae had engaged the services of Mr. Ken Starr, legal counsel, for the purpose of informing my staff and committee council of the potential consequences of making that information public. It was made clear that civil legal actions would be filed, I presume against me, if the information were to be released.

At that time, I made the decision not to release the data since there was no clear relevance to the reform effort under way, not out of concern for any litigation that might be filed. The realization that the disclosure of this information was so sensitive to the enterprise never really fully impacted me until I read the director's report. Now I understand why the enterprise was so anxious not to have public disclosure of compensation, ironically of an entity that was created by the Congress and supported by the taxpayer.

Circumstances have now changed. As a direct result of the abhorrent accounting practices, executives have been able to award themselves bonuses I do not believe they earned and I do not be-

lieve they deserve. For that reason alone, disclosure of where the money went is highly appropriate.

At the conclusion of this hearing, I will release the compensation information obtained from OFHEO and further, I will forward a letter to the director requesting that all compensation information for both enterprises be provided to the committee for a period covering 10 years for all executives that shared in any bonus distributions. This is now essential, in that OFHEO has indicated that accounting manipulation has impacted the financials on more than one occasion, therefore placing the payment of bonuses in question.

I find this very troublesome business. Much is at stake. The ability of this committee and this Congress to act will be called into question. Notwithstanding the ultimate outcome, the facts will remain and our duty will never be more clear.

Mr. Kanjorski?

[The prepared statement of Hon. Richard H. Baker can be found on page 146 in the appendix.]

Mr. KANJORSKI. Mr. Chairman, we meet today for what might well be our last hearing this year. At our first hearing in 2004, we reviewed the special examination of Freddie Mac by the Office of Federal Housing Enterprise Oversight. It therefore seems fitting that we will bookend our hearings this year with an evaluation of the findings to date of a similar examination of Fannie Mae's accounting policies and practices.

The recently released preliminary report by the Office of Federal Housing Enterprise Oversight includes a number of significant charges. The report concludes that Fannie Mae has failed to follow generally accepted accounting practices in two key areas. They are the accounting of derivatives contracts and the amortization of discounts, premiums and fees involved in the purchase of home mortgages.

The report also raises concerns about the company's organizational structure and its internal controls. These are serious matters that merit our careful attention because government-sponsored enterprises with their public responsibilities and private capital have, in my view, a special obligation to operate fairly, safely and soundly.

As we proceed today, I must urge my colleagues on both sides of the aisle to demonstrate patience and caution when approaching these matters. We should not leap to immediate conclusions. The report on Fannie Mae is preliminary. It is part of an ongoing process.

We should not overanalyze these findings because we do not have all of the information. Fannie Mae's board, as I understand, has already agreed to adopt a number of reforms based on this initial report and it may ultimately implement more. The Office of Federal Housing Enterprise Oversight continues to examine the company's books. The Securities and Exchange Commission, the arbiter of accounting standards for Fannie Mae, is now studying these matters. In short, we need to let this process work itself out.

We should also refrain from hyping these initial findings in an effort to achieve some short-term gain. As we well know from past experiences, our actions and statements on Capitol Hill have the potential to rile the capital markets. They could also raise the price

of homeownership. We should therefore practice caution, prudence and discretion.

My primary focus at today's hearing will be to determine whether the issues raised in the preliminary report constitute some form of systemic risk for Fannie Mae. I therefore intend to ask each of the witnesses their perceptions regarding this issue. I expect them each to offer me their candid assessments of these matters.

As we proceed today, I also suspect that some of my colleagues will return to the question of how best to modify the regulation of government-sponsored enterprises like Fannie Mae and Freddie Mac. As I said at our very first hearing on the oversight of government-sponsored enterprises in March 2000, "We need to have strong, independent regulators that have the resources they need to get the job done." I can assure everyone involved in these debates that I continue to support strong, world-class and independent GSE regulation.

A strong world-class and independent regulator will protect the continued viability of our capital markets and promote confidence in Fannie Mae and Freddie Mac. It will also ensure taxpayers against systemic risk and expand housing opportunities for all Americans.

Like many of my colleagues, I was greatly disappointed last year when the Bush administration rejected our bipartisan efforts to create an independent regulator. Politics, in my view, should play no role in financial regulation. It is therefore my hope that when we revisit this issue in the 109th Congress, we will continue to remain resolute and unwavering in our bipartisan efforts to create a strong, independent and world-class regulator with the powers and resources it needs to get the job done.

In closing, Mr. Chairman, I commend you for your sustained leadership in these matters and for convening this timely hearing. The preliminary report by the Office of Federal Housing Enterprise Oversight and its agreement with Fannie Mae deserve careful review and public scrutiny. I consequently look forward to hearing from our witnesses today.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 156 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Chairman Oxley?

Mr. OXLEY. Thank you, Chairman Baker, for holding this hearing on the recently released report from OFHEO's special examination of Fannie Mae. You have followed these issues closely and should be commended for your diligent oversight of the GSEs. It is my hope that this hearing will highlight the concerns raised in the OFHEO report and will help members get to the bottom of the accounting and corporate governance issues at Fannie Mae.

It is unfortunate that we are here today. After earnings smoothing at Freddie Mac was discovered, the public and the markets, and the members of the committee were assured that there were no similar issues at Fannie Mae. The findings in OFHEO's report, if accurate, are disturbing.

While we wait for OFHEO, and the Justice Department and the Securities and Exchange Commission to complete their respective tasks, the management and board of directors at Fannie Mae must

take real steps to address the issues and continue to cooperate with regulators. The agreement between Fannie Mae and OFHEO is a beginning of that process, but I seriously doubt it can be the end.

Since the enactment of Sarbanes-Oxley 2 years ago, corporate financial statements have become more transparent and more reliable. There is no question in my mind that the act is at least partially responsible for this progress. The CEO and CFO certifications of financial statements have had a profound impact on the reporting process.

Other provisions are working, too, such as the Public Company Accounting Oversight Board's inspections regime, strengthened and independent audit committees, officer and director bars, the Fair Funds, expedited disclosures of insider transactions, and internal control requirements, to name just a few. That is not to say that we can legislate integrity in every case, but we do have a sensible framework of incentives and disincentives that will affect behavior.

The OFHEO report raises serious questions about whether Fannie Mae has adequate internal control procedures, ultimately one of the core aspects of Sarbanes-Oxley. The multiple and conflicting duties of the chief financial officer, who we will hear from this morning, calls into question whether there is adequate separation between the risk-taking and control functions.

In my view, section 404 is one of the most important parts of the Sarbanes-Oxley Act. Internal control over financial reporting consists of company policies and procedures that are designed to provide reasonable assurance about the reliability of a company's financial reporting and the preparation of external financial statements in accordance with generally accepted accounting principles. Failure to comply with its requirements is not an insignificant matter. I am eager to hear from the company's senior management officials on their adherence to this critical provision.

Fannie Mae enjoys certain advantages in the marketplace not afforded to other financial companies in order to serve a public purpose. We have recently learned that the corporate structure may have fostered an atmosphere in which senior management may have had undue influence over accounting policies and procedures, and that corporate earnings and management compensation may have been manipulated.

OFHEO has worked hard in conducting reviews of the GSEs. Director Falcon and his staff have been diligent in trying to ensure that the GSEs receive the appropriate oversight. The findings of this report, if correct, reinforce arguments for the creation of a GSE regulator with the powers and authorities granted to other financial regulators and commensurate with the task of overseeing these large and complicated companies.

I was dismayed to learn that OFHEO was forced to resort to issuing subpoenas this past July in order to obtain cooperation with its investigation. It is my sense that if OFHEO had the tools possessed by other regulators, this investigation would not have reached the subpoena stage. If we had a GSE regulator with the powers and authority of a world-class regulator, it is possible that these problems at Fannie Mae would have been remedied earlier and today's hearing would not be necessary.

The OFHEO report details problems ranging from possible earnings manipulation to management structures that may not have been in line with state-of-the-art corporate governance. I am very concerned about the possibility that Fannie Mae claims to have sound corporate governance standards, when in reality these standards are not in practice.

Fannie Mae's board did the right thing in entering into an agreement with OFHEO and beginning the process of remedying the problems highlighted in the report. The OFHEO report is not finished and it is my hope that Fannie Mae will cooperate with this investigation as well as the other investigations currently under way at the Securities and Exchange Commission and the Department of Justice. Furthermore, I hope that this situation does not develop into a war among accountants arguing technical points that do not put to rest the issues raised in the OFHEO report. We owe it to the housing market and to the financial markets to quickly resolve all of the accounting and governance uncertainties.

I want to welcome all the witnesses appearing before the subcommittee today. I look forward to your testimony.

I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 148 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman, for your interest and leadership in this matter.

Ranking Member Frank?

Mr. FRANK. Thank you, Mr. Chairman.

First, I want to address a little history here. The committee here was well on the way to adopting legislation that would have enhanced the regulatory structure for Fannie Mae and Freddie Mac. In the Senate, in fact, the committee actually voted out a bill. There was some disagreement between the parties over I think a relatively minor section over receivership. I think that could have been worked out.

I believe we were well on the way, the chairman and I and the staffs, to putting together a bill that would have enhanced the regulator and could have passed. What stopped progress on a new bill was the Bush administration's determination to go beyond safety and soundness and into provisions that would have restricted the housing function.

What is powerful here are not Fannie Mae and Freddie Mac, but the interests of a majority of the members of this committee in housing at two levels. First of all, in housing in the conventional market, is very important, and the continuance of Fannie Mae and Freddie Mac are important to that. We also have a subset of issues involving affordable housing, and those are very important to many of us.

What derailed the legislation was an insistence by the Bush administration on going beyond safety and soundness and giving the regulators, for example, particular power to say, well, they are going beyond their charter in housing; they should not do these new products. There were specific issues here that transcended safety and soundness or went under it, but the administration was seeking powers that were not related to safety and soundness.

If they were to have dropped that, we would have a law already signed and in place, because on the question of safety and soundness regulation, there has not been a significant dispute.

I will give you an example of what concerns me in this regard. Many of us on this committee, contrary to what some people think, were very aggressive in pushing Fannie Mae to stay in the manufactured housing business in full fight when they were talking about retrenching, and that was bipartisan—the gentleman from Wisconsin, Mr. Green, myself and others, because you will not get the kind of homeownership we want at the right demographic.

As to safety and soundness, manufactured housing is an example. I do not expect Fannie Mae and Freddie Mac to make as much money as possible on every single entity. The attitude of OFHEO towards manufactured housing is an example of why I am concerned about making sure the regulator has safety and soundness powers, but not general powers. In manufactured housing, it was those of us on this committee, Democratic and Republican who care about housing who pushed Fannie Mae to stay in it.

When I wrote to the secretary of HUD to ask him to join us, the answer was, several members did, he was much too busy for that, his scheduler told us, and we could go talk to the head of FHA. So that is the issue.

Finally, turning to this report, I have to say that I read the director's testimony and I will talk to him about it again, I regret what seems to me frankly almost boilerplate in his report that says at the end of every specific, and this could raise safety and soundness issues. It could, but nothing in here seems to me that it does.

To the extent that people played games to get bonuses, I am outraged. People making that much money, let me put it this way, at the level of compensation of the top officers of Fannie Mae, they should get bonuses if they rush into a burning building to rescue a kid, maybe a cat, but not for doing their job. I think it is unseemly of them to be getting bonuses in the first place for doing what they are getting paid very well to do.

To the extent that there was manipulation, that is very wrong and should be penalized. But I have seen nothing in here that suggests that the safety and soundness are at issue, and I think it serves us badly to raise safety and soundness as a kind of a general shibboleth, when it does not seem to be the issue.

Last point, and Fannie and Freddie are to some extent criticized from both ends. There was an article by Gretchen Morgenson in the New York Times on Sunday that said the problem is that they have done too much to bring housing to people who really cannot afford it and should not be given this chance to own the housing. Her article said the problem here has been they have overextended by lending money to people who were below the economic level that should be there.

On the other hand, they are criticized by the chairman of this subcommittee for not doing enough for lower-income people. Both obviously cannot be right. I think what we need to do is to go forward as we were ready to do with a tougher safety and soundness regulator, but in ways that do not impinge on Fannie's and Freddie's ability to do a better job than they have been doing with

affordable housing and to continue to do the job they have been doing with regard to housing in general.

Chairman BAKER. Mr. Shays?

Mr. SHAYS. Thank you.

I am new to this committee and I was absolutely shocked when we looked at Enron and WorldCom. The board of directors did not do their job. The management did not do its job. The employees did not speak out. The lawyers in the firm were facilitators. The rating agencies did not do their job. It scared the hell out of me, frankly.

We passed Sarbanes-Oxley, which was a very tough response to that. And then I realized that Fannie Mae and Freddie Mac would not even come under it. They were not under the 1934 Act. They were not under the 1933 Act. They play by their own rules, and I am tempted to ask how many people in this room are on the payroll of Fannie Mae, because what they do is they basically hire every lobbyist they can possibly hire. They hire some people to lobby and they hire some people not to lobby so that the opposition cannot hire them.

Fannie Mae has manipulated, in my judgment, OFHEO for years. For OFHEO to finally come out with a report as strong as it is tells me that has got to be the minimum, not the maximum. I congratulate OFHEO for finally stepping up to the plate and not being manipulated by the very organization they are supposed to regulate.

I hear these arguments that Fannie Mae and Freddie Mac are looking out for the interests of the homeowners, and they score worse in helping minorities than the private sector banks under the 1934 Act and the 1933 Act.

Fannie Mae and Freddie Mac are very generous to members of Congress and very generous to the organizations of caucuses in Congress. They do not have to disclose what they do. They do not have to play by the same rules. They are going to crash if this Congress does not wake up and do something about it.

I am absolutely shocked at the extraordinary tolerance that has taken place in this Congress. This is just the beginning of the story. What did OFHEO say? They said they have accounting methods and practices that did not comply with generally accepted accounting practices, employed an improper cookie jar reserve in its accounting system, deferred expenses to meet compensation targets, did not have proper corporate governance controls in place.

We need to wake up and the sooner we do the better it will be for Fannie Mae and Freddie Mac and all their investors, and the better it will be for our government.

Chairman BAKER. The gentleman yields back.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

This is indeed an important hearing. I am very much concerned about the direction that Fannie Mae is moving in. Fannie Mae does an extraordinarily important function in our society, unique among companies in terms of being a catalyst to increase homeownership among middle-income and lower-income individuals. So this is a very important hearing.

Last year, Freddie Mac, another corporation with similar duties, had one of the largest corporate financial restatement of earnings

and saw the ouster of its top executives. Fannie Mae representatives assured us then, on this subcommittee, that their books were clean and that they should not be associated with Freddie Mac's problems.

Now, we are meeting to discuss OFHEO's report, which shows that Fannie Mae inappropriately reduced earnings volatility and provided management with the flexibility to determine the amount of income and expense recognized in any accounting period. In 1998, the management at Fannie Mae needed an earnings-per-share target of $3.23 in order to receive the maximum bonus for the company. Due to the accounting schemes used by Fannie Mae, the executives just hit the earnings-per-share mark and they earned bonuses totaling nearly $6 million.

I think the general issue before the public and people all across this country is simply, has the time come to decide if companies that violate public trust should continue to receive special treatment. I think the fundamental question here is, why the Fannie Mae board believed it was appropriate to link executive pay to earnings per share, and whether this compensation scheme resulted in inappropriate incentives for management.

Whether or not the reasons that the company altered earnings was to achieve bonuses is not yet known. The report is there and we have these hearings to get to the bottom of it. I submit to you that we must get to the bottom of it so that we can give Fannie Mae a clean bill of health. The Department of Justice has opened up a criminal investigation into the allegations of the report, and that investigation may clear up the intent.

Congress should carefully review the OFHEO report because the special examination is continuing and ongoing. Questions have also been raised about OFHEO's ability itself.

Chairman BAKER. Can the gentleman quickly wrap up?

Mr. DAVIS.—to act on this report and the method by which the report was released.

I certainly look forward to the hearing from the panel's testimony on the OFHEO report and Fannie Mae's report to address the criticisms of its accounting practices.

Chairman BAKER. I thank the gentleman. The chair to the best of its ability will try to keep members' opening statements to the requested 5-minute statement length.

Mr. Castle?

Mr. CASTLE. Thank you, Mr. Chairman.

The issue before us is an important one today. I share the concerns of a lot of the other members who have spoken about it, a number of the issues that are before us. It is vast and it is disturbing and hopefully we can do something about it. Frankly, I think we should have done something about it before we started down this alley. Perhaps we can now.

I am going to keep my opening comments, Mr. Chairman, to one issue that concerns me, in what appears to be multiple interpretations of generally accepted accounting principles, GAAP. In February 2004, OFHEO hired Deloitte & Touche to examine the accounting policies of Fannie Mae.

Specifically, OFHEO's report finds fault with the company's accounting treatment of, one, the amortization of premiums, dis-

counts and fees related to the purchase of mortgages and mortgage-backed assets, understatement of accounting financial standards, SFAS 91; and two, financial derivative contracts under SFAS 133. KPMG LLP, Fannie Mae's auditor, has stated it stands behind its audit work.

Fannie Mae has also stated they believe they were following generally accepted accounting principles. I am concerned that two different auditors would have different interpretations of SFAS 91 and SFAS 133. Therefore, I have sent a letter to Robert Hertz, chairman of the Financial Accounting Standards Board, FASB, for their comments on SFAS 91 and 133, and whether these standards need to be readdressed to remove any gray areas that may exist.

If improper accounting has occurred, I question how these accounting practices were allowed to occur and what was management's knowledge of these actions. It bothers me greatly to hear the allegation that accounting tricks were used to meet specific earnings-per-share targets that resulted in vast amounts of executive compensation to be paid.

I thank all of our witnesses for appearing before us today and I hope we will have an exchange on the merits of what has occurred and what needs to occur in the future. I welcome the news that OFHEO and Fannie Mae have reached an agreement to address the improper accounting and internal controls within Fannie Mae. I strongly believe, however, that in light the likely reforms achieved in the passage of the Sarbanes-Oxley Act, we must again be prepared to act.

Mr. Chairman, I would ask unanimous consent to insert the text of my letter to Chairman Hertz for the record. With that unanimous consent, I will yield back the balance of my time.

Chairman BAKER. I thank the gentleman. Without objection, the letter will be included in the official record.

I am advised by staff that the opening statement period for members is 3 minutes, not 5 minutes.

Mr. Clay?

Mr. CLAY. Thank you, Mr. Chairman.

Mr. Chairman, we are rushing to judgment today. OFHEO has released a preliminary report which has not been proven, but leaked to the press. During the course of the examination, Fannie Mae was not given the chance to respond to OFHEO findings. Informal communications, which are at the core of the GSE's oversight statute, were essentially ignored. At least one former examiner of OFHEO questioned the political motivations behind OFHEO's rush to judgment.

Mr. Chairman, we do not normally hold hearings on matters before other investigations are complete. Internal findings are normally discussed informally and remedies proposed. There are other stages of this process that take place before a judgment is rendered. Why circumvent the process? Why this hearing?

If I were a member of Fannie Mae's board, I would find the environment very intimidating. Mr. Chairman, why is Senator Shelby not holding a hearing on this preliminary report? After all, the Senate Banking Committee reported out legislation on the GSEs. Maybe this hearing agenda is about something more than the accounting procedures at Fannie Mae.

As you know, Fannie Mae recently entered into an agreement with OFHEO in which they focused on accounting, internal control, and capital. Fannie Mae has agreed to increase additional capital by 30 percent. I am not sure how the new requirement promotes affordable housing. Within 45 days OFHEO and Fannie Mae will implement additional internal controls. The Securities and Exchange Commission, as is intended, should be the final arbiter of GAAP. Why can't we let the SEC decide this issue? Why must we rush past them?

This hearing is about the political lynching of Franklin Raines. We have seen this happen too many times before. We are to go out of session and the deed is to be done before the election. Why can't we just say that this is the agenda? Let us debate that issue on its own merit. Better still, let due process take its course and let the chips then fall where they may. That is, unless this is truly a witch hunt.

We are having a trial by OFHEO leaks, trial by newspaper articles, and trial without due process. In this case, the Senate has it right.

Chairman BAKER. The gentleman yields back.

Mr. Royce?

[The prepared statement of Hon. Wm. Lacy Clay can be found on page 151 in the appendix.]

Mr. ROYCE. Thank you, Mr. Chairman. I thank you for holding this hearing on the OFHEO report allegations of accounting and management failure at Fannie Mae, as it is called. I would like to commend you, Mr. Chairman, for your continued leadership on GSE oversight.

While there is no question as to where I stand on GSE issues generally, the fact of the matter is the GSEs have a special relationship to the government. After all, there are not many institutions that share common characteristics with Fannie Mae, such as a charter created by Congress, an exemption from local taxation, an exemption from certain SEC registration and fees, and an ability to borrow from the U.S. Treasury Department under certain circumstances.

With this in mind, I believe that Fannie Mae and GSEs in general have an important obligation to conduct operations to the highest standard. As a member of this oversight subcommittee, I expect Fannie Mae to be a role model to other businesses as it fulfills its federally mandated mission. Fannie Mae should be conducting operations in a safe and sound way. In my view, this should include strong internal controls in the risk management department, coupled with consistent and conservative applications of accounting rules.

With its newly released report, the Office of Federal Housing Enterprise Oversight has called into question many of Fannie Mae's risk-mitigating practices. This is very troubling to me and there is no doubt that OFHEO has placed the burden on Fannie Mae to answer these allegations. As OFHEO has leveled some very serious charges, I recognize that we do need to give Fannie Mae the opportunity to respond. This hearing is part of the process for this committee to learn more facts, and I appreciate the participation of all the witnesses today.

In addition to our important oversight role in this committee, I hope that we will move swiftly to create a new regulatory structure for Fannie Mae, for Freddie Mac and the Federal Home Loan banks. There is a very simple solution. Congress must create a new regulator with powers at least equal to those of other financial regulators such as the OCC or the Federal Reserve.

I hope this committee will heed the advice of Chairman Greenspan and the entire Board of Governors, the Federal Reserve Staff, the U.S. Treasury Department, the OECD, the IMF and countless others who have urged Congress to act.

Now, on the approach that was rejected by the Bush administration and, by the way, was rejected by myself and many others on this committee. Why was that approach rejected by the Fed, by the Treasury? Because that legislation was not a true effort at reform as it failed to address several of the key issues that are essential to true reform of the regulatory regime of the housing GSEs.

Specifically, that non-reform effort would have created a regulator without the authority to raise capital standards, without the authority to place an ailing GSE into receivership, without the authority to oversee all aspects of a GSE's operations, leaving much of this oversight at HUD.

Chairman BAKER. Can the gentleman begin to wind up?

Mr. ROYCE. I will wind up right now by saying there is a difference of opinion on which approach to take if we really want a world-class regulator. I thank you again for the opportunity for this hearing and for us to hear from these witnesses today.

Chairman BAKER. I thank the gentleman.

Mr. Baca?

Mr. BACA. Thank you very much, Mr. Chairman and Ranking Members. Thank you for holding this hearing. I appreciate the opportunity to hear from witnesses about these very important issues.

These are very complex rules and it is possible that we are not going to see a resolution until the issue is decided by the SEC. As I understand it, there are three broad areas of inquiry involving accounting, internal control, and capital. I would simply say I am not going to pre-judge the issues, and that before any stones are cast, we should see that there is culpability. Judge not and not be judged.

Our country is a country of laws, and there is a process that must be followed and respected. Make no mistake, we will follow this process wherever it may lead. At the end of the day, if anyone, and I stress anyone, has not respected the law they will face the consequences.

Mr. Chairman, I think it is important that in rushing to judgment that we not destroy an institution that is helpful in providing assistance for first-time homebuyers and minorities. Fannie Mae is an integral part of our economy and many of our constituents have been able to realize the American dream of homeownership due to its programs.

I am concerned that the regulators follow the procedure that exists for investigating potential concerns in a way that is consistent, and respectful of confidentiality and impartial. We need to follow proper procedures in handling audits before they go public. We

should ensure that the process is fair. We should ensure that the process is fair in getting the facts. And that we engage in corrective action if there are any deficiencies.

Like most of us have been involved in nonprofit organizations where we had auditors that audited us. They come back with a report. They give an opportunity to make corrections if any are done. And all of us have been involved in nonprofit organizations and on boards of directors. We know the consequences if those procedures are not followed.

I think it is important that we keep the politics out of what should be and historically has been a nonpolitical process. It concerns me that OFHEO has been Fannie Mae's regulator since 1992. OFHEO has been its regulator since 1992, and all of a sudden issues are being raised. The regulators had an opportunity in the past to address any concerns.

So we need to ask: What, if anything, has changed? This is not about headhunting. It is about positive steps to correct any problems. I look forward to hearing the witnesses.

I yield back the balance of my time. Thank you very much, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman, and thank you for holding the hearing. I also want to thank, of course, the witnesses for appearing today. I look forward to hearing their testimony, as I know everybody does, so without objection I will submit all of my written statement for the record. I just have a couple of comments.

OFHEO's recent report on the activities of Fannie Mae asserts the company engaged in accounting practices that do not comply with the generally accepted practices. Of course, it is troublesome. In addition, the report raises concerns about deferred price adjustments, derivatives and hedging activities, internal control issues. I think the stopgap measure was a good thing to implement.

According to OFHEO and what we have read, they are serious and it raises concerns regarding the validity of previously reported financial results. OFHEO's findings to date are obviously very serious. Right now, if you would read the accounts in the papers, it looks like the management of Fannie Mae is basically looking at the fact of, in the media at least, of making them a poster child for regulatory reform.

It is important to keep in mind, though, that the examination is still in the process. So the newspapers and the way people are looking at it is one thing, and the reality of what we are going to find out today I think is important, and the process that OFHEO will finish is obviously important, and also the SEC is going to be the final arbiter of compliance with the general accounting practices, and has not yet, as I understand, offered its opinion on Fannie's accounting methods. So that is another part of this puzzle I think that will be out there for us to look at.

Of course, Fannie was chartered by Congress to create a secondary market and improve the function of home mortgage markets. I think that we can all agree that the United States mortgage and credit markets are the envy of the world. A strong, vibrant housing market is important to everybody.

There can be no doubt that we have to take some steps to strengthen the GSEs by establishing a new world-class regulator. How we do that and who is to be that regulator, I do not know today. With the growing presence of GSEs in the capital markets and the possible risks they pose to the financial system, the cost of a safety and soundness regulator would be a prudent step. But I want to add the big "however." That "however" is we have got to proceed in this endeavor with caution. It cannot be mixed with politics.

If we want to talk about politics or press reports or lobbyists, maybe we ought to do a bill to ban lobbyists, then we can have a rich Republican and a rich Democrat do the lobbying for everybody. We could call them the 527s of lobbying. So I think we take that kind of talk out of the process because any new regulatory structure has to recognize the importance of the GSEs to the secondary mortgage market.

Everyone agrees that strong regulatory oversight is critical to maintaining public confidence in this remarkable system. As I have said before, enhanced regulations for GSEs should not impede their ability to support affordable housing in America.

So I applaud the chairman for this hearing. I think we have to state a public policy as we go down this road and do what is right for the good of Americans, and to craft public policy that ensures safety and soundness, but let's not throw in this process the housing market to the wolves because that hurts the average American.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Ms. Inslee?

Mr. INSLEE. Thank you.

I just wanted to follow up. Our ranking member talked about, when you talk about evaluating this, we are looking at soundness. It made me sort of think of our obligation of buying a horse. You check its soundness. You check its teeth. You check it for hoof rot. That is an important part of this function here, to check on soundness of Fannie Mae.

But the problem to date has been some folks do not want to check for soundness, check its teeth, check it for hoof rot. They want to hobble the horse when it comes to being a main stem of the housing supply in this country. Whatever comes of these hearings, I hope that we keep in mind those two different functions, that we ought to focus on soundness, but not allow this what may be, and I do not know yet because I think you should have the trial before the execution, but it may be very unfortunate things that occurred, to hobble this very, very important horse that is carrying the U.S. economy in residential homes in this country.

Thank you.

Chairman BAKER. I thank the gentleman.

Ms. Kelly?

Mr. KELLY. Thank you very much, Mr. Chairman.

I have no statement at this time. I look forward to these witnesses.

Chairman BAKER. Mr. Toomey?

Mr. TOOMEY. Thank you, Mr. Chairman. I want to congratulate you for your long work in this hearing and for holding the hearing today.

I just want to make one quick observation. Many folks have already observed that there are considerable complexities in the accounting issues that we are going to be addressing today. I think it is important to make sure we make it very clear up front, and not get bogged down in the complexities of some of this accounting because the dispute here that is alleged, I should say the allegation that is made by OFHEO, is not that there is a dispute over the interpretation of ambiguous and complex rules over which reasonable people could disagree, but rather the allegation is that there has been a pattern of invention of accounting policies and devices which systematically and intentionally misrepresent financial statements for the purpose of smoothing earnings and achieving maximum bonuses.

Now, if these allegations are true, they are obviously extremely disturbing and require I think major changes at Fannie Mae. That is what we are going to be talking about and hopefully shedding some light on today, not the arcane interpretation of accounting rules, but whether or not accounting rules were being set aside, and different policies were adopted for purposes for which they certainly should not have been.

I think that is what we need to focus on, Mr. Chairman. I thank you for holding this hearing and I yield the balance of my time.

Chairman BAKER. I thank the gentleman.

Ms. McCarthy?

Mr. MCCARTHY. Thank you, Mr. Chairman.

I will hand in my statement. I certainly do appreciate hearing from the chairman and the ranking members, but we are into this hearing 45 minutes and we still have not heard from the witnesses, and I personally think that we should be talking to the witnesses, and then do our statements and ask questions.

With that, I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

Mr. Bachus?

Mr. BACHUS. I thank the chairman.

First of all, chairman, there have been several remarks made that we would have addressed these issues had it not been for the Bush administration. It is my recollection that the Bush administration actually urged this committee and this Congress to take strong action and that at that time that was in the sort of post-Freddie Mac. At that time, many of the Democratic members accused the Bush administration of going on a witch hunt against Fannie Mae of saying that things were right at Fannie Mae, and that OFHEO was doing a wonderful job, and that there was sufficient regulation, that this was simply to accuse the Bush administration of wrong motives.

It was actually a combination of those in the Senate that did not want to take action, and members of this committee that disagreed with the Bush administration. One thing the Bush administration was concerned about is the new products that Fannie was offering, and they wanted Treasury to approve those new products. It is my

recollection that the minority members almost to a person resisted those reforms.

I do think, and I commend Mr. Frank. Mr. Frank actually had it right and more accurately when he said the Bush administration wanted to go further than this committee. I think that is absolutely true. And now all of a sudden, some of the things that the Bush administration wanted to do it seemed like they would have been very prudent things to have done.

So to try to, a month before an election, to try to somehow create a smokescreen that the Bush administration had done something wrong would be inaccurate and would not be factual. Of course, it probably is not surprising either.

We have before us today OFHEO, and Fannie Mae and their officers will be before us at a later date. My understanding of this hearing is we are to examine OFHEO and you are to testify as to the agreement that you have made with Fannie Mae as a result of your study of their accounting practices, and that in fact you found that they violated two important accounting rules.

My questions would be, all this stuff that you have discovered now, why wasn't it discovered 3 or 4 years ago, since you have been the regulators for years and years. Why is it suddenly coming to light?

Chairman BAKER. Could the gentleman begin to wrap up?

Mr. BACHUS. So I would simply say that I think there are some tough questions for Fannie Mae, but I think there are also some tough questions for OFHEO because I believe that if they have done these things and you were the regulators, you should have known before just the last few months. This should have come to light.

Thank you.

Chairman BAKER. The gentleman's time has expired.

Mr. Hinojosa?

Mr. HINOJOSA. Chairman Baker, over the last 4 years, the United States has suffered from immense job loss. We have suffered from an increase in the number of people living in poverty. We have witnessed an incredible and unsupportable switch from federal budget surplus to an ever-growing budget deficit.

We have also experienced a tremendous increase in the national debt over the last 4 years. Overall, our economy has not been performing very well during this period, with oil prices exceeding $50 per barrel. In fact, to say that it has been underperforming would be an understatement.

However, there is one sector of our economy that has been performing well consistently, and that is the housing market. It has served as the foundation of the U.S. economy since the stock market declined many years ago. It is the one sector of our economy to which we need to pay the most attention at this time. We need to nurture it. We need to ensure that nothing we do here in Congress harms it.

At this point, I think we need to keep our powder dry until all the ongoing accounting and adequacy of its capital and the quality of management investigations are complete. Then we can see where everything stands once all the dust settles.

Having said that, Mr. Chairman and Congressman Kanjorski, I look forward to hearing the testimony of all of today's witnesses.

I yield back the remainder of my time.

Chairman BAKER. I thank the gentleman.

Ms. Brown-Waite?

Ms. BROWN-WAITE. Thank you very much, Mr. Chairman. Thank you for your leadership in providing this opportunity for the committee to address this important issue.

I would also like to thank our witnesses for coming to the committee this morning.

As Americans, we have heard in the past couple of years about the Enron scandal and other corporate examples of "cooking the books." As members of Congress and members of this committee with oversight over the mortgage and housing industries, it is imperative that we ensure that companies with as much industry clout as Fannie Mae, are following generally accepted accounting principles, or GAAP.

I was listening to Bloomberg the other day, yesterday as a matter of fact, and I heard how much your stock has also suffered. So there is obviously a rippling effect of this OFHEO report. However, that being said, as committee members we have to remember that the report released by OFHEO in September is early in its preliminary stages. I think that there are more accusations in this report than findings.

We certainly look forward to hearing how OFHEO completed this report. We have had some heartaches with corporate scandals in this country, but I do not think we should be jumping to conclusions. While we are ensuring that Fannie Mae is using honest GAAP-compliant principles, the committee also needs to be certain that we are giving Fannie Mae a fair chance to be heard.

Coming from Florida where our state was devastated by hurricanes and where a lot of rebuilding is going to take place, it is obviously important that we have the availability of the funding for home construction that Fannie Mae regularly participates in.

I look forward to hearing what our witnesses from Fannie Mae have to say, and I want to again thank you, Mr. Chairman.

I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

Mr. Lucas of Kentucky?

Mr. LUCAS OF KENTUCKY. Mr. Chairman, I look forward to hearing from the witnesses.

Chairman BAKER. I thank the gentleman.

Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman.

I am going to be brief. The one thing I do not want to forget are the good things that Fannie Mae is doing. I hear Enron talked about here this morning. This is not Enron. This is not the Enron situation. These are clearly violations of accounting principles, but let's not go overboard and make this a criminal proceeding.

I am very interested in hearing exactly what the differences in the accounting practices and how we can correct them. But this should not be a witch-hunt. This should not be a political exercise in punching people who have done a lot of good things in this coun-

try providing housing opportunities for a lot of people that need them. But clearly, we have to get our house in order here.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Gillmor?

Mr. GILLMOR. I will enter my statement into the record. Thank you, Mr. Chairman.

Chairman BAKER. The member's statement and all members' statements will be made part of the official record.

Mr. Miller?

Mr. MILLER OF CALIFORNIA. Thank you. I would like to thank you, Mr. Chairman, for your continued commitment to ensuring the safety and soundness of the secondary market.

The question of impropriety has surfaced as a result of allegations of accounting irregularities at Fannie Mae has sent shock waves through the strong housing market. That market has kept this nation going in recent years. The United States housing market is the envy of the world. We enjoy the lowest interest rates and the highest homeownership of any developed nation in the world.

When Americans are homeowners, it spurs economic and community development and provides residents with a sense of pride in their community. Homeownership is the single largest creator of wealth for most Americans. For this reason, it is imperative that we work through this process to maintain a strong housing market.

The GSEs have been at the forefront of creating affordable housing opportunities for American families. In my district, for example, Fannie Mae has created employer-assisted housing programs for the city of Boreas Police Department to allow police officers to live in the communities they serve. They also helped to finance affordable housing initiatives in Anaheim, California, and Anaheim is an extremely high-cost housing area.

Across the district, they have been able to offer innovative programs to allow those with blemished credit to afford the dream of homeownership, to help seniors convert the equity in their homes into cash to help them meet their needs, and to help families and individuals with special needs become homeowners.

All of this, in partnership with lenders, is intended to meet the ever-growing need of our communities. As we address deficiencies in GSE supervision, we must not lose sight of Congress' original goal in chartering GSEs. The mission of Fannie Mae and Freddie Mac is to provide stability and ongoing assistance to the secondary market for residential mortgages, and to provide access to credit and homeownership in the United States.

As we move forward to make much-needed regulatory reform to ensuring the safety and soundness of GSEs, Congress must be unwavering in our commitment to help Americans achieve the dream of homeownership and continue to ensure the accessibility of mortgage funds at the lowest cost. We must completely understand the implications of changes in the regulatory structure in meeting the goals of the charter, being careful not to inadvertently hinder the ability of GSEs to be innovative in meeting the needs of potential homebuyers.

I believe Congress has ample evidence that OFHEO may not have the experience necessary to appropriately regulate complex fi-

nancial institutions such as Fannie Mae and Freddie Mac. OFHEO released annual reports that the internal and external audit functions at Fannie Mae exceeded safety and soundness standards and had the appropriate independence. How can we be confident in such findings when OFHEO is now issuing a report with very different troubling findings about the serious accounting irregularities at Fannie Mae?

We must work to ensure a new regulatory regime under which investors in the market can be confident that these companies are sound and that their investment in America's housing markets are safe. While there is no question that regulatory change must be made to ensure that GSEs are held to the absolute highest standard of ethical conduct, I urge my colleagues to remain mindful that strong regulations provide a means to achieve our ultimate goal of expanding the supply of affordable housing credit across our nation.

Mr. Chairman, I again want to thank you for holding these hearings. The goal of these two companies is so critical to our economy. I look forward to working with you to ensure the appropriate regulatory reforms are made.

I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Ford?

Mr. FORD. I am sorry. I do not have anything to say. I am a believer that when you hold hearings, you should let the witnesses talk.

So I welcome you all and look forward to hearing from you.

[The prepared statement of Harold E. Ford, Jr. can be found on page 152 in the appendix.]

Chairman BAKER. A commendable attitude.

We have two members who are not members of the subcommittee today, but who are members of Financial Services. I would like to recognize them at this time.

Ms. Waters?

Ms. WATERS. Thank you very much, Mr. Chairman. I would ask unanimous consent to make a brief opening statement.

Chairman BAKER. Without objection, please proceed.

Ms. WATERS. I appreciate the opportunity to be here today. I must share that I feel like I am in another round in the battle between FM Watch and the GSEs. FM Watch, financial institutions that decided a long time ago to wage a political war to reduce the GSEs' share of the mortgage market, and of course I must say, Mr. Chairman, led by you.

OFHEO has gone from weak and ineffective to the extreme of accusing Fannie Mae now of questionable accounting practices in order to increase their bonuses. They have gone back to 1996. That is a serious allegation. I hope they are prepared to prove it. Obviously as we explore the safety and soundness issues that are the subject of this hearing, all of us on the Financial Services Committee must keep our eye on the housing mission of the GSEs, particularly the affordable housing mission that we have entrusted to Fannie Mae and Freddie Mac. As we proceed, it is critical that we ensure any action that we may consider not impair the housing mission of the GSEs.

Mr. Chairman, I note with interest that the 211-page OFHEO report from Mr. Dickerson to Director Falcon that we will explore in today's hearing still bears the following notation on each page: special examination of Fannie Mae, privileged and confidential disclosure, and/or duplication prohibited, even though the OFHEO report was posted on the OFHEO Web site and has been publicly available for almost two weeks.

Mr. Chairman, as I understand it, normally the examination and regulatory process is a confidential process where the regulator raises his concerns with the party being examined and the regulator gives that party a full opportunity to respond before determining whether regulatory action is required? I note that when Director Falcon's September 20 letter expressing concerns about Fannie Mae made the papers, the OFHEO report had just been completed. By September 22, the September 17 OFHEO report was publicly available, and by September 27, an agreement had been signed between Fannie Mae and OFHEO. It seems highly unlikely to me that the normal kind of regulatory dialogue could have occurred within this timeframe.

So I hope that the witnesses will address whether the regulatory process was proper, or whether there were public disclosures outside the normal process for reasons having nothing to do with safety and soundness. The September 7th OFHEO report is fairly characterized as a work in progress. As Mr. Dickerson notes in his transmittal memo to Director Falcon, it contains the findings to date of the special examination of Fannie Mae.

The report raises a number of highly technical and arcane accounting issues, including issues concerning the treatment of derivatives. Some of these issues appear to be controversial, and may be disputed by Fannie Mae. These issues cannot be easily summarized and they may not lend themselves to a brief and simple response. I hope that we will have the patience to give these issues the time that they may require.

Mr. Chairman, to my knowledge, apart from a few brief press releases from Mr. Raines and Fannie Mae's independent director, Mrs. Ann Korologos announcing the intention of Fannie Mae to cooperate with the OFHEO investigation, and later announcing the September 27 agreement between OFHEO and Fannie Mae, there has been no in-depth public response by Fannie Mae to the substantive allegations contained in the OFHEO report.

This is the first chance that our committee and the public will have to hear Fannie Mae's response to these allegations, and it will be good to hear their side of the story. I am particularly concerned about the 30 percent capital set-aside or surplus requirement because that takes a lot of money out of the market for mortgages.

Thank you. I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman.

I just want to express my thanks to the chairman for allowing members who are not part of the subcommittee to participate in the hearing.

I think members of the subcommittee have expressed in various ways a number of the concerns that I would have expressed had

I been a member of the committee. At the end of the day, we want to make sure that Fannie and Freddie and whatever other institutions are available to encourage and support increased homeownership and housing in this country are made stronger and more vibrant.

I also share a number of the process, due process and fairness concerns that have been raised by various members of the committee. So I am here to participate in this for those reasons, because I am a supporter of housing for American people and because I believe in fairness and process and due process, and not convicting somebody before the process runs its course.

I hope we will keep in mind both of those things, and I appreciate the chairman allowing us to participate. I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

If there are no further opening statement by members at this time, I would now proceed to recognize our first witness for the hearing today.

Mr. Armando Falcon is the director of the Office of Federal Housing Enterprise Oversight, who I understand today is accompanied by Ms. Wanda Deleo, chief accountant, and Mr. Christopher Dickerson, chief compliance examiner, Office of Federal Housing Enterprise Oversight.

Before I proceed, I am reminded, I have a statement of Mr. Roger Barnes, former manager of financial accounting, deferred assets in Fannie Mae's controller division, submitted to the committee and asked to be made part of the official record. If there is no objection, I now move to incorporate that into our hearing record.

[The prepared statement of Roger Barnes can be found on page 197 in the appendix.]

By prior agreement with Mr. Kanjorski, we have determined that given the gravity of the hearing content today, that all witnesses should be asked to testify under oath, given the fact that this is an investigative hearing.

Mr. Falcon, do you have any objection to testifying under oath?

Mr. FALCON. Not at all, Mr. Chairman.

Chairman BAKER. It is my understanding that you are accompanied by staff. Will they be testifying and answering questions during the course of your testimony today?

Mr. FALCON. They will not have testimony, Mr. Chairman, but they will be available to the committee to answer any technical questions about the report.

Chairman BAKER. In that light, it would be my opinion and advisable, should we solicit information from them, that each of you take the oath. Do either of you have any objection to testifying under oath if required by the committee?

Ms. DELEO. No.

Mr. DICKERSON. No.

Chairman BAKER. If that is the case, I would ask that you now stand and raise your right hand and affirm the oath.

(WITNESSES SWORN)

Chairman BAKER. Thank you. Each of you is now considered to be under oath.

Mr. Falcon, I would recognize you. Given the importance of your report, we customarily limit our witnesses to 5 minutes in presentation. I would encourage you to summarize as best you can, but should you find the need to exceed 5 minutes, I am certain members of the committee would welcome a full and complete discourse from you on this matter.

Please proceed at your leisure.

STATEMENT OF HON. ARMANDO FALCON, DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. FALCON. Thank you, Mr. Chairman, and thank you Ranking Members Kanjorski, Frank and Chairman Oxley, who was here earlier, for inviting me to testify about OFHEO's special examination of Fannie Mae. As always, my testimony reflects my own views and are not necessarily those of the secretary of HUD or the President.

Before getting to my comments on the report, I would like to introduce two of my staff who you mentioned earlier. On my right is Chris Dickerson, OFHEO's chief compliance examiner and one of our derivatives experts. On my left is Ms. Wanda Deleo, our chief accountant. Both are leading the work of the special examination, and they are here to assist me in answering any technical questions the committee may have about the report.

In July of last year, I announced that OFHEO would conduct a special examination of Fannie Mae's accounting policies, internal controls and financial reporting. While the special examination continues, our safety and soundness mandate requires that when we find problems, we move quickly to remedy them, rather than wait until the entire examination is complete. The report represents our findings to date and it serves as the basis for the actions that we have taken.

The report raised such serious safety and soundness concerns that we brought them to the immediate attention of the board. To the board's credit, it became very engaged in the examination and moved quickly to reach an agreement with OFHEO on the plan of remediation. The agreement constitutes an important first step towards resolving OFHEO's concerns and ensuring safe and sound operations at the enterprise.

Let me now turn to the substance of the report. It documents Fannie Mae's pervasive and willful misapplication of generally accepted accounting principles, as well as critical operational deficiencies. The report's findings have implications in four areas of major concern to OFHEO: the validity of Fannie Mae's previously reported financial results; the adequacy of its regulatory capital; the quality of senior management's supervision of the enterprise; and Fannie Mae's overall safety and soundness.

The accounting violations cannot be dismissed as mere differences of opinion in accounting rules. Fannie Mae understood the rules and simply chose not to follow them. Fannie Mae's development of improper accounting policies and practices can be traced back to a corporate culture and operating conditions characterized by the following: a desire on the part of senior management to portray Fannie Mae as a consistent generator of stable and growing earnings; an ineffective process for developing accounting policies;

an operating environment that tolerated weak or nonexistent internal controls; key person dependencies and poor segregation of duties; incomplete and ineffective reviews by the enterprise's office of auditing; an inordinate concentration of responsibility rested in the chief financial officer; and an executive compensation structure that rewarded senior management for meeting goals tied to earnings per share, a metric that can be and was subjected to senior management manipulation.

The accounting problems at Fannie Mae that OFHEO has uncovered relate mainly to FAS 91 and FAS 133. Let me briefly describe each. FAS 91 governs the amortization of balances related to mortgages and mortgage-related securities. Management developed accounting policies and selected and applied accounting methods to improperly reduce earnings volatility related to amortization. Fannie Mae improperly delayed the recognition of income to create a cookie jar reserve that it could dip into whenever it best served the interests of senior management. Those interests included smoothing earnings and meeting earnings-per-share targets linked to executive bonuses.

An important example of how this worked took place in 1998. At that time, external events caused a plunge in interest rates, which in turn added to an acceleration of mortgage pre-payments. As a result, Fannie Mae faced a more rapid premium amortization in the enterprise's mortgage portfolio than expected. In December, management's own amortization models specified that $400 million in premium amortization expenses had to be recorded on Fannie Mae's books in 1998. However, management decided to record only $200 million of the $400 million that year.

Fannie Mae deferred the remaining $200 million to 1999 and recorded it incrementally throughout that year. KPMG, Fannie Mae's outside auditor, decided the enterprise's action on this matter as an "audit difference," a term which means that KPMG disagreed with Fannie Mae's action. Had Fannie Mae taken the full $400 million charge in 1998, senior managers would have lost their eligibility for any bonuses. That is because incentive compensation depended on Fannie Mae realizing earnings-per-share targets.

As it happened, the earnings-per-share target which would secure senior management the maximum bonus could only be reached if Fannie Mae recorded no more than $200 million of the expenses in 1998.

The next year, Fannie Mae kicked off a challenge grant initiative which promised to reward management for doubling earnings in 5 years. To avoid facing amortization problems similar to those in 1998, senior management began a prolonged and concerted effort to develop policies for managing amortization. The goal was to gain earnings flexibility and the ability to minimize earnings volatility. In this regard, the 1998 violation was not a singular event. It represented a continuous effort to artificially guarantee success in meeting targets.

Let me now turn to FAS 133 and hedge accounting. FAS 133 requires that derivatives be marked to market and that changes in fair value be included in earnings unless the derivative is designated as and qualifies for hedge accounting. We have found that Fannie Mae implemented FAS 133 in a manner that placed earn-

ings volatility and maintaining the simplicity of operations above compliance with GAAP. These goals to an inordinate degree influenced the development of Fannie Mae's approach to hedge accounting.

The prerequisites for receiving hedge accounting treatment include effectiveness assessment, ineffectiveness measurement and proper hedge documentation. Because Fannie Mae has not met these critical requirements, it should not receive hedge accounting treatment for many of its derivatives. Instead, proper accounting for such derivatives requires that their fair value changes be recorded directly through earnings.

As a result of these issues and Fannie Mae's disregard for complying with FAS 133, we are concerned about the validity of the amounts Fannie Mae has reported in accumulated other comprehensive income, the earnings the enterprise has presented in prior quarters, and the adequacy of regulatory capital.

Let me state plainly that Fannie Mae's accounting was just wrong, and must be fixed properly. The stakes are too high to just forgive past sins. If any company, especially a government sponsored enterprise, is allowed to get away with this type of accounting misconduct, then no regulator can do its job and no investor is safe. A regulator and an investor must be able to trust the books and records of a company.

Regarding internal controls, OFHEO found that Fannie Mae maintained a deficient accounting policy development process, key person dependencies and poor segregation of duties, all of which contributed in important ways to the enterprise's problems. The details of these matters are addressed in the report.

As I mentioned earlier, we took prompt and appropriate action to address these serious problems. We entered into an agreement with the board requiring that Fannie Mae implement correct accounting treatments, hold the 30 percent capital surplus, recalculate prior period financial statements using correct accounting, appoint an independent chief risk officer, and put in place policies to ensure adherence to accounting rules and new internal controls.

I would also like to remind the subcommittee that the special examination is continuing. If OFHEO discovers more problems, we will take further action.

Finally, I would like to thank the leadership of the full committee and the subcommittee for your support for our funding. The current continuing resolution has placed severe constraints on our ability to hire additional staff and employ outside experts for the continuation of the Fannie Mae examination. This could not come at a worse time for the agency, and it once again illustrates the need to remove OFHEO from the appropriations process.

Mr. Chairman and members of the subcommittee, I have tried to summarize the report as best I could. I would like to ask that it be placed into the record, and we are prepared to answer any questions that the subcommittee may have.

[The prepared statement of Hon. Armando Falcon can be found on page 160 in the appendix.]

Chairman BAKER. Your full testimony and the report content thereof will be included in the official record of the committee.

Mr. Falcon, did you find that management of Fannie Mae had adopted and implemented a strategy from a managerial perspective to steer accounting reports for two important goals. One is to present an image of very stable earnings to the broader market; and two, to manage EPS calculations to enable maximum bonus payments to be achieved for executives?

Mr. FALCON. Those are the findings contained in the report, Mr. Chairman.

Chairman BAKER. Did you find in at least one instance in 1998 that manipulation of accounting methods inconsistent with GAAP resulted in an EPS calculation which enabled the bonus payment to executives that they would not have been entitled to if accounting practices consistent with GAAP had been utilized?

Mr. FALCON. That is the situation we described in 1998, yes.

Chairman BAKER. Is it correct that in reaching the earnings-per-share trigger of $3.23 that the calculation of 3.23 in carried to the math resulted in a calculation of 3.2309. Is that correct?

Mr. FALCON. Yes.

Chairman BAKER. Has it been established why the decision was made to defer $200 million of a $400 million unexpected expense was deferred from 1998 into 1999 and not any alternative amount?

Mr. FALCON. We have not received an adequate explanation as to why that was done. We do know that their external auditor disagreed with that action that was taken.

Chairman BAKER. Is it correct that in at least preliminary response that the modeling utilized by the enterprise was determined by management to be inaccurate and the feeling was expressed that the $400 million expense was actually overstated, and their view was that by deferring the $200 million it perhaps would more reflect economic reality?

Mr. FALCON. Their own internal modeling for amortization clearly demonstrated that they had to take this $400 million expense in 1998. It was their internal models that they were relying on for amortization expensing.

Chairman BAKER. But they believed that model to be accurate?

Mr. FALCON. Yes.

Chairman BAKER. Then there is no justification. My understanding was the $200 million had been deferred because a preliminary explanation is that the modeling was believed to be inaccurate and had overstated the expensing. More importantly, in the subsequent four quarters in 1999, the expensing did occur, acknowledging the value, and in fact did not the expensing require increases over the $200 million originally calculated?

Mr. FALCON. Let me say something to that. I cannot speak to what the company believed as far as this amortization in 1998. I can say that we believe that it was not justified under generally accepted accounting principles, and that $400 million should have been recognized in 1998.

Chairman BAKER. Is it correct that there are, because many will allege or suspect to allege, that this was a one-time dispute over arcane accounting methodologies? Their outside audit, you indicated, agreed that the expense should not be deferred and should be taken in 1998. Is that correct?

Mr. FALCON. Yes.

Chairman BAKER. Isn't it correct that there were other accounting irregularities identified in other reporting years that placed the earnings calculation in question, and therefore the subsequent bonus calculations resulting from those earnings?

Mr. FALCON. I am sorry?

Chairman BAKER. Let me restate. Is it correct that you identified in the course of your examination other accounting irregularities and inconsistencies in other reporting years that placed the earnings for those years in question because of the accounting methodologies utilized, and therefore would result in placing the bonus payments made to executives in question?

Mr. FALCON. Yes.

Chairman BAKER. Going forward, I wish to reiterate that this is an interim report, not a final report. You engaged the services of Deloitte & Touche as an outside audit team to assist your staff in reaching these conclusions. In the course of that examination, you have reviewed, your staff, Deloitte & Touche, in excess of 200,000 documents and e-mails over the course of the past 8 months. In addition, hundreds of interviews and depositions taken.

This report should be understood as a first step, not a final step. As I understood in your opening statement, as you discover additional information that should be brought to the attention of the committee, you intend to do so. Is it appropriate or can you comment today on where your next focus of attention will take you within the enterprise's activities?

Mr. FALCON. I think I cannot at this time, Mr. Chairman, but I can tell you that we do this as a two-step process here. The first step in this review on these issues was to identify whether or not——

Chairman BAKER. Let me do this, Mr. Falcon. I hate to cut you off, but my time has expired, and I am going to try to hold other members to be accountable. I have one wrap-up question that is important for me to ask.

Given the public statements to date by the executives and board members of Fannie, and the testimony I have reviewed that Fannie will proceed with today, in essence disputing all of your findings, placing your accounting judgment in question, the disputes with the opinion of your outside audit firm, the fact that you have had to request the issuance of subpoenas to get the enterprise to respond to your normal course of inquiry, do you believe the culture of mismanagement at Fannie Mae will change unless significant personnel alterations are required, as they were at Freddie Mac?

Mr. FALCON. This comes down to a question of whether or not we have sufficient confidence in management to promptly implement the remediation plan that will be required to put the company back fully on sound footing. The issues raised by our staff in this report certainly do cause doubts about whether or not there is sufficient confidence in management going forward, such that there should not be management changes at the top of the company.

We are currently considering that and we are having discussions with the board about the issue of management accountability and the confidence in current management.

Chairman BAKER. I regret our time is so limited.

Mr. Kanjorski?

Mr. KANJORSKI. Let me ask the first question right off. Is there a systemic risk problem at Fannie Mae, in your opinion, at this stage of the preliminary report that you have gone through?

Mr. FALCON. I think that we have managed this process in a way such that there is not substantial risk of a systemic disruption. Through the actions we have taken, and through the board's prompt action in agreeing with us on remedial actions, we have precluded the possibility of systemic events.

Mr. KANJORSKI. So we can inform the investing public and others that hold securities of Fannie Mae, is there any reason in the world that they should worry about the value or the credibility of their securities?

Mr. FALCON. I am not quite comfortable talking about recommending whether or not an investor should or should not invest in this company.

Mr. KANJORSKI. I am not asking you to make a recommendation. Is there anything in your findings, in other words, as a result of the audit differences that are being attended to, and as a result of some of the accounting wrongs that may have been uncovered through your investigation, is there any reason to believe that there is a large loss of equity or a question of Fannie Mae remaining solvent?

Mr. FALCON. In the worst-case scenario, the company could be undercapitalized, below its minimum capital requirement, but not to the extent that the company would be insolvent.

Mr. KANJORSKI. Can you give us a maximum amount of undercapitalization that you may have discovered? In other, the need to infuse more capital, what would that amount be?

Mr. FALCON. Now that we have determined that the accounting policies of the company were not consistent with GAAP, the next step for us to take is to do an evaluation of the impact of these improper accounting practices on past financial statements, especially the impact of its large derivatives portfolio possibly not being eligible for hedging accounting treatment, which means the amounts in other comprehensive income would have to flow back into the balance sheets through earnings, and therefore be recognized.

We will not know this until we go through all of the evaluation exercises. There are $12 billion in negative losses in OCI, and if all of that were forced to move over to earnings, the company could potentially take a hit of that much. But we do not know, congressman, how much, if any of that will move into the retained earnings portion of balance sheets until we have worked with the company to come to those determinations.

Mr. KANJORSKI. Making the worst-case scenario assumption, however, that does not constitute in your mind systemic risk? Is that correct?

Mr. FALCON. Yes. The solvency of this company is not threatened by the findings we have to date.

Mr. KANJORSKI. Okay. I want to move you along because I have a few questions.

I do not understand what you do as a regulator, but I assume you examine auditors' reports. Is that correct?

Mr. FALCON. Yes.

Mr. KANJORSKI. And I assume that audit differences, as you indicated, how they handle the $400 million or the $200 million, showed up in a finding by the auditor to the corporation that was a difference here of opinion and how this should be accounted for. Is that correct?

Mr. FALCON. What we do——

Mr. KANJORSKI. Not what you do. I want to know what papers you examine. What I am asking you is did you examine the audit report of 1998 and did there exist a finding indicating there was a difference between the auditor and the corporate leadership as to how this $400 million was accounted for?

Mr. FALCON. We were not aware of this audit difference until we began this accounting examination.

Mr. KANJORSKI. Why were you not aware of it?

Mr. FALCON. We have not traditionally looked at the work of the external auditor to ensure that they were properly certifying that the company's financial statements were consistent with GAAP.

Mr. KANJORSKI. Do you mean the regulator does not get the outside audit report and examine it thoroughly before it passes, or examines anything else in a corporation? I would think that would be the first tool that you would look at.

Mr. FALCON. Let me ask our chief accountant about this question, Mr. Kanjorski.

Ms. DELEO. We are certainly taking that approach at this point.

Mr. KANJORSKI. I am not worried about 2004. I am asking about 1998. I am trying to get an essence of just what a regulator does. The only prior experience that I have had sitting on a board of a bank was that we would have external audits and at the conclusion there would be an exit meeting of all the differences or questions raised by the auditor that would be presented to the audit committee.

It just seems rudimentary that if you are going to spend hundreds of thousands or maybe millions of dollars to hire an auditor, that all of that is laid out in the findings and the differences, and that should be the first piece of paper the regulator picks up and looks at because a lot of work has been done and a very credible auditing company has made differences in findings. In 1998, if we had picked up the audit report by the external, outside auditor, was there a reflection of an audit difference in how that $400 million was handled?

Chairman BAKER. I would ask the gentleman that that be the last question on this round.

Please respond, sir.

Mr. FALCON. Yes. We look at this, Congressman, as a team effort. The safety and soundness of this company is dependent, yes, on us doing our job properly. It is dependent on management running the company properly, the board properly overseeing the company, and the external auditor doing its work to ensure that the financial statements are consistent with GAAP. We look at the financial statements and the work of the external auditor. I do not know where this audit difference was reflected.

Mr. KANJORSKI. I just want to follow this line of questioning. You mean at this point in time you do not know whether or not that was openly displayed in the outside audit report?

Mr. FALCON. Let me ask Mr. Dickerson, please, Congressman, to address this.

Mr. DICKERSON. Congressman, we had testimony from the controller and the CFO that there was this $200 million audit difference between the firm and KPMG. We saw internal documents from the company that there was approximately a $400 million expense that was estimated.

Mr. KANJORSKI. And it was listed as an audit difference by the outside auditor in 1998.

Mr. DICKERSON. Right. And we learned that through testimony that we obtained from the CFO.

Mr. KANJORSKI. It took you 6 years and depositions to discover something that was on a concluded audit document as a finding?

Mr. FALCON. We need to go back and find out if this was included in any documents that were or should have been provided to the agency. If we find that this was something that was in some documents that we could have had access to, that we should have had access to, then it points out a need for us to strengthen our program.

I am not saying that the agency is completely without fault here. We have more resources now, with an accounting staff. We did not have an office of chief accountant until 2 years ago. Ms. Deleo has just joined the agency very recently. But in light of the Freddie Mac problems, I think it has highlighted a need for this regulator to get heavily involved in accounting issues because they do go to the heart of the safety and soundness of our work. If we cannot rely on the books and records of this company——

Mr. KANJORSKI. Yes, but you do not read the books and records of this company as a regulator. It does not matter. It would just seem to me that this committee could call up and subpoena the outside audit report of 1998 and I will be shocked if a finding is not there mentioning this audit difference as to how the money was handled. It should have been the first day you arrive at the place, looking at the audit. You should know what happened.

I am just worried about, we are calling you a regulator and you are scaring hell out of me that you did not see that, and everybody should have been alerted to that that sits on a board, that you go through your audit findings. That is so axiomatic. I guess in law school we used to call that Horn book.

Chairman BAKER. The gentleman's time has really expired, if I may. I really want to try to hold members. We have much more to do today. Please help me here to get through this process.

Mr. Castle?

Mr. CASTLE. Thank you, Mr. Chairman. Even by Washington standards, this is an extraordinarily tangled web that we are dealing with here and a little bit hard to follow to a degree.

Fannie Mae clearly has some questions to answer here. I am worried that we have not given the regulators, OFHEO in this case, sufficient assets to move ahead with what they have to do in terms of their work. There are a lot of people hired on the outside to try to hold all this off. Frankly, I think we have a responsibility as a subcommittee and a committee right here to do everything we can to get to the bottom of all of this.

Let me just start with this, if I may, Director Falcon. And that is, as I understand it, you hired an outside auditor recently. Did you not hire an outside auditor prior to that time because of insufficient funds to do so?

Mr. FALCON. We have not hired an outside auditor to assist us prior to the initiation of this special accounting examination. That is right.

Mr. CASTLE. Was it because you had insufficient funds to do so?

Mr. FALCON. We have been trying to. We have not undertaken a special accounting review like this prior to this point. We have not made the request, I guess, for the funds. But even if we saw the necessity for it, we would not have had the funds and we would have had to come to Congress for the additional funding.

Mr. CASTLE. Let me ask you another question. Can you tell me why, and I can only judge this through press statements of my own accord. KPMG is standing by the company's financial reports, even after your report, of course. Could this be another example of just a difference of opinion as to the application of GAAP, such as the one I understand you have with this company with regard to their manufactured housing loans? Or is it something else?

Mr. FALCON. We feel very strongly that these are black and white accounting issues. These are not issues of interpretation. They are not issues where reasonable people can disagree. We have taken prompt, strong action in trying to deal with this because we do think they were clear violations of accounting principles.

Mr. CASTLE. So i.e. KPMG then in standing by this is at fault in terms of the clear accounting principles which exist. Is that what your statement is basically?

Mr. FALCON. If they are standing behind this accounting treatment, then yes, they are wrong as well.

Mr. CASTLE. Do you have sufficient powers to carry out your responsibilities? I know there has been a lot of discussion about changing agencies and all the things that we should do, but I am worried about what you can do now in terms of cease and desist orders, other regulatory powers which you need, the funding which you need in order to carry out your responsibilities to make sure all this is handled correctly.

This is of overwhelming significance, and I think for you to be shortchanged in any of these categories would be a terrible error. Can you detail for us where there may be needs, or if there are not needs at all?

Mr. FALCON. I think there are several key areas where we would like the same powers that are given to every other safety and soundness regulator. It begins with the authority to assess for budgetary needs outside the appropriations process, to have independent funding. It begins with flexibility in a variety of areas, including capital requirement setting. Every other regulator has that.

It includes issues like independent litigating authority, the ability to freeze the pay of any executives where we find potential wrongdoing. We recently had an opinion in district court saying that we do not have the same authority that other regulators have. So there are quite a few areas where we just need strengthening across the board, including general safety and soundness powers.

Mr. CASTLE. Changing the subject, I wrote down a couple of comments, and I do not know if I wrote them down correctly, of course. Correct me if you see otherwise, but that you made in your opening statement. You said that Fannie Mae understood the rules, but chose not to follow them.

Mr. FALCON. Yes.

Mr. CASTLE. What do you mean, Fannie Mae? Do you mean their board of directors, their officers? What do you mean by Fannie Mae in that circumstance? And are the rules that you are referring to accounting rules or something beyond anything that has been discussed here today?

Mr. FALCON. What we mean is, this is not a matter where the rules were too complex and the company did not understand them. It is not a matter where they made a good-faith effort to try to comply with the rules. They did not comply with rules that they clearly understood.

Mr. CASTLE. Accounting rules?

Mr. FALCON. Accounting rules.

Mr. CASTLE. That they clearly understood. And when you say "they," you are referring to whom?

Mr. FALCON. Those responsible in the company for setting accounting policy consistent with GAAP.

Mr. CASTLE. So it could be officers or it could be directors or a combination of the two or something of that nature?

Mr. FALCON. Yes.

Mr. CASTLE. Okay. And then you said it is just plain wrong and must be fixed and not overlooked. I assume that is just a follow-up to what you had said earlier in this particular area. When you say "fixed," if a mistake was made, do you mean going back and just correcting the accounting principles? Or is there something further that needs to be done to so-called "fix" their problems?

Chairman BAKER. That would have to be the gentleman's last question.

Please respond, sir.

Mr. CASTLE. Thank you, Mr. Chairman.

Mr. FALCON. It means making sure that the proper accounting policies are put in place going forward. If there was an impact on their financial statements going backward, that it would mean that there would be a need to correct those financial statements going backwards. That is an issue that we are working with the SEC on.

Mr. CASTLE. Thank you, sir.

Chairman BAKER. I thank the gentleman.

Ranking Member Frank had to step out. Just for the committee's purpose, I have committed on his return to recognize him in the proper order for his questions.

Mr. Clay, you are up next.

Mr. CLAY. Thank you, Mr. Chairman.

Mr. Falcon, when you and members of OFHEO's staff conducted interviews and received company documents, why was Fannie Mae not allowed to question their witnesses on the record?

Mr. FALCON. They were allowed to participate in those sessions. I am not aware if they requested such opportunity, but the interviews of their employees were held at our request in order to gath-

er information about the company's accounting policies and practices and internal controls.

Mr. CLAY. Why were Fannie Mae officials not provided the opportunity to respond to findings or conclusions reached by OFHEO during the course of the examination?

Mr. FALCON. I think because we followed a regular order here. We followed an accepted practice of regulators. Faced with findings of significant accounting misconduct by senior management and dealing with a management that is resistant to regulation, that same management team responsible for this accounting misconduct, any regulator would have done what we did, take this directly to the board.

Mr. CLAY. Is this due process?

Mr. FALCON. This is safety and soundness regulation which requires prompt action to ensure that the company does not get into financial difficulties.

Mr. CLAY. Is this the way you have handled internal investigations in the past?

Mr. FALCON. Other than the Freddie Mac special accounting review, this is only the second special examination that we have conducted. On more routine matters like our ongoing annual risk-based examination of the enterprises, we do have that type of a give and take, but this was a different situation.

Mr. CLAY. In May and June of 2003, OFHEO published its 2002 annual report giving both companies, Fannie Mae and Freddie Mac, more than satisfactory grades on accounting and internal controls. You and your agency were pretty embarrassed when issues were discovered at Freddie Mac. Were you so determined to not let this happen again even if it meant denying Fannie Mae fundamental fairness that is routinely provided to banks?

Mr. FALCON. No, congressman. I have testified before this committee before that I had no reason to believe that this company was engaged in any kind of accounting improprieties like Freddie Mac. But given the fact that questions were being raised about whether or not the same problems existed at Freddie Mac, I thought it appropriate to go in and take a look at Fannie Mae. So we did. I am as disappointed as I think you are that the company has engaged in this type of conduct. But the findings are what they are, and we have taken action.

Mr. CLAY. Let us go back to the process, then. Examiners discuss preliminary concerns and possible findings with regulated entities. Would it not have been fair to do this with Fannie Mae, to sit down and have a discussion with them?

Mr. FALCON. We did have a discussion, but it was with the board, congressman. Like I said, this was a situation where we have findings of serious accounting misconduct by management and we have that same management being resistant to our efforts to deal with these issues, noncompliance with our efforts to examine the company such that we had to go to the Justice Department and ask for a court enforcement of our subpoena. In such situations, any regulator would have gone directly to the board, brought the matter to the board's attention, and sought immediate action to ensure the safety and soundness of the company.

Mr. CLAY. You did not provide Fannie Mae with a draft examination report. Banks are given an opportunity to respond before finalizing an examination report or discussing matters with their company's board. Why not Fannie Mae in this instance?

Mr. FALCON. We do that. In the course of our normal examination of the company, we do that. But as I have said, this is a different situation.

Mr. CLAY. And you claim that they were hostile to the examiners. In what way?

Mr. FALCON. They were resistant to compliance with our request for documents and we had difficulty in scheduling their employees for interviews. We eventually had to move to taking statements on the record, rather than having informal interviews of employees. We had to move to the issuance of administrative subpoenas. We had to ultimately try to get those subpoenas enforced in court.

Mr. CLAY. Don't you think that all interests are best served by ensuring that all relevant data is available to OFHEO and that there are no misunderstandings of relevant facts?

Mr. FALCON. I am sorry, Congressman. That all relevant data is available to——

Mr. CLAY. To your agency and there are no misunderstandings of relevant facts.

Mr. FALCON. Yes.

Chairman BAKER. That will need to be the gentleman's last question. His time has expired.

Mr. CLAY. Did he answer?

Chairman BAKER. He did respond, I believe "yes."

Mr. CLAY. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

Director Falcon, 3 years ago our committee was heavily involved in the accounting scandals surrounding Enron and WorldCom and others. We saw, based on our hearings and evidence, manipulation of earnings, corporate governance failures, raiding of corporations by their executives in order to pad their own wallets.

After reading your report, it seems that you are alleging many of the same problems now exist at Fannie Mae. As you know, the Sarbanes-Oxley Act was formulated to prevent future Enrons, but has been repeatedly criticized in some quarters as being too tough on corporations. Do you believe that Sarbanes-Oxley has been a useful tool in your investigation? And do you believe that Fannie Mae's executives were in violation of the Sarbanes-Oxley Act?

Mr. FALCON. I think it has been a very useful tool, Mr. Chairman, because the spirit of Sarbanes-Oxley is accountability, accountability of management and accountability of boards in corporate governance issues. Here we have a situation where because of the requirements of Sarbanes-Oxley, I think the board has stepped up to try to begin to fulfill its responsibilities. They have worked with us well in coming to an agreement. We are working on developing a good relationship going forward to address any future problems.

The provisions like certification certainly are beneficial. There is much at stake when an executive certifies compliance with the pro-

visions of Sarbanes-Oxley. It has been a very useful tool for the agency, because we also have safety and soundness standards that our patterned off of Sarbanes-Oxley as well.

Mr. OXLEY. How does your job working with the regulated entity, that is Fannie Mae, and in the context of Sarbanes-Oxley regarding the SEC, explain to the committee a little bit about how, as a technical matter, that works?

Mr. FALCON. We are working with the SEC. Now that Fannie Mae is a registered company under the 1934 Act, they are covered by Sarbanes-Oxley. We are working with the SEC. We have shared with them all of our findings. We are sharing our documents with them, everything that they have requested. We have a shared interest here. Our interest is safety and soundness. The SEC's interest is investor protection. We are each working to make sure that our missions are fulfilled here. Sarbanes-Oxley has encouraged that kind of interagency cooperation between the safety and soundness regulator and the SEC to make sure that both interests are properly served.

Mr. OXLEY. Director Falcon, Fannie Mae is one of the largest users of derivatives in the world. As such, Fannie Mae should be well versed with the rules related to FAS 91 and FAS 133. Is it your understanding that Fannie was aware of the fact that their accounting was not GAAP compliant, but they chose not to comply because, to do so, would be too burdensome and costly? Or is it your opinion that Fannie Mae made a material misapplication of the GAAP rules?

Mr. FALCON. I think it is both, Mr. Chairman. One, they wanted to maintain the accounting principles that they thought were best suited to the company. At the same time, they willfully did not apply accounting rules properly. This is an important point because it was not just a matter of these rules being too complex for this large, very sophisticated company. They understood the rules. They chose not to follow them.

These accounting principles have to mean something, Mr. Chairman, and they should apply to every company equally. No one gets special treatment. What we have done in this report is to highlight the issues of how the company has not complied with some very critical accounting rules. The company will not get special treatment from us. I do not think anyone should give it special treatment in making sure it complies with all accounting principles.

Mr. OXLEY. The Sarbanes-Oxley Act clearly spells that out. So you are saying that basically this was a selective effort on the part of Fannie to use accounting principles that would benefit them, as opposed to what we would consider to be generally accepted accounting principles as enunciated by the FASB and ultimately the rules set up by Sarbanes-Oxley and the SEC and the Public Company Accounting Oversight Board.

Mr. FALCON. That is right. They simply did not comply with GAAP because compliance with GAAP would have shown more volatility in their quarterly financial statements than they would have liked. So through the misapplication of GAAP, they were able to project an image of the company of smooth earnings, which conveys to the markets less risk than is actually there because of the volatility of strict compliance, of proper compliance with GAAP.

Mr. OXLEY. Okay. So the issue is a selective interpretation of GAAP. I would assume that Fannie will come before the committee later today and argue that basically it was a difference of opinion over those issues, and that they were clearly compliant with the GAAP and that you had a different interpretation as to whether that was procedurally correct. How would you respond in advance to almost certainly they will be testifying to?

Mr. FALCON. It would not surprise me, Mr. Chairman, that that would be their position. We have found, not just our chief accountant and her staff, but also Deloitte & Touche, we have found that these are clear violations of generally accepted accounting principles. They are not situations where a company can say that they may have been aggressive; they may have been consistent in spirit. No, these were noncompliance with GAAP.

We would not have come to the very firm conclusions we did in this report and not have taken prompt corrective action were it not for the fact that these were clear violations of GAAP. If any company were allowed to engage in this type of accounting misconduct, then no investor could rely on the books and records of the companies and their financial statements.

Mr. OXLEY. This will be my last question, Mr. Chairman.

As you know, in Sarbanes-Oxley we specified that insider stock sales, instead of the traditional 40-days recording requirement, would now be made in real time, that is within 24 hours of that sale. Did your investigation look into insider, that is corporate executives, stock activities? If so, what did it tell you?

Mr. FALCON. We have been monitoring the sales of individuals within the company. We are just now beginning to shift our focus into other areas like that. Our first objective here was to assess compliance with GAAP in these two critical accounting areas, and now move to remedy those problems and get to valuation issues. But issues like the insider stock sales are something that we have been monitoring and perhaps we will come back and give you a report on that.

Mr. OXLEY. It would seem to me at least that perhaps would be the SEC's role because the Act required them, the insiders who sell stock, to report that on the Web site at the SEC. And so, I would assume that at least the SEC would assume that particular role and that OFHEO would be secondary in that regard. Is that correct?

Mr. FALCON. Yes. They are publicly disclosed, and the SEC would have a role in that.

Mr. OXLEY. They would have the primary role, would they not, under the law?

Mr. FALCON. They would have a primary role, but safety and soundness requires that we also take action. There is some overlap. Safety and soundness requires that we also take action when we see violations. It is important that we do coordinate with the SEC in areas where there is overlap.

Mr. OXLEY. The purpose, of course, of the provision, as Chairman Baker knows and others on the committee, was to provide more transparency in real time because perhaps if we had that on the books during the Enron case, some of those insider sales would have put up a lot of red flags, particularly when the employees

were locked down and not able to sell their shares. So that is why I wanted to bring that point up, the idea of the immediacy of it and the transparency of it hopefully, at least at some point, will provide some deterrent to that kind of behavior, including perhaps smoothing out earnings or making earnings look better than they really are.

With that, I yield back.

Chairman BAKER. I thank the chairman.

Mr. Scott?

Mr. SCOTT. Yes, thank you, Mr. Chairman.

Mr. Falcon, there have been some questions raised as to the timing of the release of your report. Could you describe the manner in which this report was released, the timing of it? Were there systematic leaks to the press? Were they internal? And the affected parties such as Fannie Mae were aware of your findings before they were released to the press?

Mr. FALCON. We have kept a tight lid on this as we have gone through the process. The first communication we had about this report as we got to the end of it was on Friday, the day before we met with the board, I do not remember the exact date, congressman, but we did contact the company and asked that the board assemble itself so that we could present the report to the board.

We did not release the report to anyone prior to that date. The first time we released the report outside the agency was to the board at that date. We did have on the Friday before that Monday meeting, some conversations with other agencies just to make them aware of what we were finding and how we were going to proceed.

Then once we went to the board on Monday, the week progressed with discussions between us and the board about proper remedial action.

Mr. SCOTT. Let me ask you this, then, at what point did you release it to the press in that order of events? When exactly did you do that?

Mr. FALCON. We did that on Wednesday. I had a commitment to the board that we would not release the report as long as they objected, and we were in the process of working out the terms of this agreement to take care of remedial actions. On Wednesday, I had a meeting with a couple of the board members. They said that given the intense interest in this, they no longer had any objections, and given the fact that there was also some expression raised from members of Congress about go ahead and put the report out there, I exercised my judgment and said, okay, then we will go ahead and release the report.

Mr. SCOTT. Okay. Did you consult with the Securities and Exchange Commission or FASB prior to making the report's findings public, as to whether or not Fannie's accounting was consistent with GAAP?

Mr. FALCON. We spoke to the SEC about this on the Friday before we went to see the board. Prior to that time, we did not seek their opinion about this. Because we viewed these issues as clear violations and the company clearly understood these rules, we did not. If we felt that this involved a gray area and we needed some guidance about what the rules required and whether or not the

company was meeting those rules, then we would have certainly sought guidance from the SEC.

Mr. SCOTT. Okay. Two little points here. How are the problems with accounting for derivatives at Fannie, how do they compare with what you have found with the examination of Freddie Mac? Are they the same? Same abuses?

Mr. FALCON. We have seen the same cultural issues. We have seen the same motivations in terms of smoothing earnings. Some role in compensation issues. So certainly much of that appears to be consistent between the two companies.

As far as the actual magnitude of any impact on the company's financial statements, I really do not have an answer for that until we complete this next phase of the process, which is to assess the impact on past financial statements.

Mr. SCOTT. Why do you think that Fannie Mae altered their earnings? What was the underlying purpose from your report?

Mr. FALCON. The primary rationale as we see it was a strong desire that the company had to present itself to the public and investors as a company which had very smooth and consistent and reliable earnings growth. The only way to do that was to develop these accounting practices which allowed them to smooth out the volatility which exists in this line of business.

Mr. SCOTT. Do you think that this activity was generated on the part of Fannie Mae so that they could increase their compensation package?

Chairman BAKER. That would need to be the gentleman's last question. His time has expired.

Please respond, sir.

Mr. FALCON. It certainly appears that way to us. Given this one instance in 1998 and given the fact that for the next 5 years bonuses were continually tied to earnings per share as a metric. That metric was being manipulated in order to create smooth earnings. It certainly appears that way to us.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Shays?

Mr. SHAYS. You are almost becoming a sympathetic figure, and your organization. I mean, you have issued a report and you are getting attacked on the report. You are being questioned why you did not do a better job sooner, and yet your organization has not been given the authority or the power by Congress to do the job it needs to do.

And frankly, I do think you needed to show a little more energy, which you are starting to do. I am seeing the result of that. When did you give them the report? When did you talk to them? Why didn't you find out sooner? Instead of having members of this Congress try to find out what the hell they did.

One of the things that I find somewhat astounding is, are you saying to this committee that you actually had to issue subpoenas against this organization or consider it or threaten it to get information you are entitled to get?

Mr. FALCON. We issued administrative subpoenas to get information that we needed for this special examination, yes.

Mr. SHAYS. Why would you have to issue administrative subpoenas? Why can't you just ask for it?

Mr. FALCON. We did initially, but we did not get sufficient compliance, certainly not timely compliance, partial compliance. Therefore, we felt the only way to solve that problem was to move toward administrative subpoenas.

Mr. SHAYS. So the bottom line is, not only have you found this company not in compliance, you are telling us they resisted in your initial efforts to find out what was going on. They resisted your efforts to do your job. Isn't that correct?

Mr. FALCON. That was our feeling and that is why we moved toward the more formal processes.

Mr. SHAYS. And you have stated to us that these findings are very serious, correct?

Mr. FALCON. Yes.

Mr. SHAYS. Are investors impacted? Isn't it possible that investors, based on reports, will have made decisions that were based on faulty information?

Mr. FALCON. Unfortunately, that very much is the case when you have financial statements issued under accounting practices that are not consistent with GAAP. GAAP is there to ensure consistency of reporting across quarters so that you have the ability to compare a company's performance from quarter to quarter. If you do not have correct compliance with GAAP, then you do not have that comparability from quarter to quarter and can judge a company's performance over time.

Through these catch-up provisions the company had under FAS 91, it allowed it to minimize earnings volatility and that comparability that investors need.

Mr. SHAYS. And didn't it also enable them to say they were a low-risk enterprise?

Mr. FALCON. The lack of volatility certainly conveyed that impression.

Mr. SHAYS. Now, having discovered what you have discovered without the cooperation of the organization, are they accepting your findings or resisting your findings?

Mr. FALCON. I feel like the board has been cooperative in working with us to address these findings.

Mr. SHAYS. Right. And they said that they will change their behavior, correct?

Mr. FALCON. They said they would change their behavior going forward. They are going to do the calculations for us going backwards so we can assess the magnitude of the incorrect accounting in prior periods.

Mr. SHAYS. What concerns me is, when Mr. Raines comes and testifies, he is not going to give us the feeling that he gets it. Why do you think that is the case?

Mr. FALCON. I cannot speculate on that. I just know that our findings, we feel very strongly about what we found. A lot of work has gone into this. It does not surprise me that the company would continue to stand behind its accounting, but the fact is it is wrong.

Mr. SHAYS. It is wrong, and there is not going to be any doubt about the fact that it is wrong. Now, their auditor was paid $3 million in a $1 trillion firm. Doesn't that raise some question about

their capability, the auditor's capability to do the job, with a $1 trillion operation?

Mr. FALCON. We are now focusing more on the work of the external auditor. We have had concern about potentially excessive reliance by the external auditor on the internal audit function and internal policy-setting by the company, but that is something for further review now that we have completed this step in the process.

Mr. SHAYS. I congratulate you on the work you have done. I congratulate you for trying to protect the public. I congratulate you for showing courtesy to the company, meeting with them first before this report was issued. But the bottom line is, what really matters is what your report says and how they deal with it. I am somewhat appalled and maybe even a little shocked that you would have had to use subpoenas to get information to do your job. I thank you for going to that level to ensure that you could get your information.

Chairman BAKER. The gentleman's time has expired.

Ranking Member Frank?

Mr. FRANK. Thank you, Mr. Chairman.

Let me say, I was pleased and I understand what the gentleman said. I guess, if your feelings have been hurt. I am sorry. I did not think anybody here was of that sensitivity. I was pleased to join with the chairman in objecting to the appropriations committee to level-fund you going forward, but we thought that was the best thing we could do was to get you more money, and the chairman of the committee and I jointly protested the decision of the Appropriations Committee, but being in the minority we do not get to make those appropriations decisions, but we were certainly supportive of that.

I did have a couple of questions. This is important about how this was done, because I think there is a problem that a perception could be created before we can establish a reality that could be damaging. Now, you told the gentleman from Georgia how you went about telling people, et cetera. But there was a newspaper report over that weekend I think quoting the chairman of the subcommittee. He said he had been briefed on the content of the report. We on our side, on the Democratic side, heard nothing until we read about it in the paper. Was the chairman briefed and is it appropriate to brief one side and not tell the other?

Mr. FALCON. That would be certainly not appropriate and not consistent with the way I would like to deal with this committee, congressman. We did not brief any member of the committee. Unfortunately, the press just reported that inaccurately.

Mr. FRANK. Wait. Stop. The press mis-reported it. All right. Maybe that will make it into the reports of today's proceedings.

So the report that the chairman had been briefed was an error on the part of the press. He was not briefed.

Mr. FALCON. Yes.

Mr. FRANK. Okay.

Chairman BAKER. Would the gentleman yield? I just want to confirm. I do not know where the report generated. I was not either by SEC or OFHEO given any advance information.

Mr. FRANK. Okay. I appreciate that. I would just caution people, and we now have an agreement from all parties that the assertion that OFHEO had briefed the chairman of this committee was a

mistake in the press. If that is the only mistake the press has made in this, that would be quite extraordinary.

Let me ask you, similar. There was one report in one newspaper that you had made a referral of a criminal matter to the Justice Department. Is that accurate?

Mr. FALCON. We have not made a formal criminal referral. All we have done is given a copy of the report to them.

Mr. FRANK. To everybody. So that means you have not made a criminal referral as that is defined.

Mr. FALCON. Right. We have not made a formal referral.

Mr. FRANK. Okay. That is another one again. I think the suggestion that there was a criminal referral is it seems to me quite misleading. I am glad we were able to clear that one up.

Now, on the question of the substance, Fannie Mae has agreed to a 30 percent increase in their capital. Is that correct, as a result of your conversations with them?

Mr. FALCON. Yes.

Mr. FRANK. How did you arrive at the decision to make it 30 percent? My understanding is, as I read this, the smoothing out of earnings, if that happened, to give people more pay is outrageous, but it does not seem to me to implicate in any way the safety and soundness. A smoothing out means up one and down another. It does not affect certainly the overall economic position.

Then the question is the derivatives and the hedge accounting. The potential misstatement there is I guess part of the reason that you asked for the 30 percent increase in capital because it might have been a misstatement.

But my understanding is you have come to no conclusion as to what the amount of a potential misstatement was. Is that correct?

Mr. FALCON. That is correct.

Mr. FRANK. Could it have been an under-estimate as well as an over-estimate?

Mr. FALCON. Potentially.

Mr. FRANK. So what we know is that you disagreed with the way they did them. I was struck, and I would ask unanimous consent to put in the record here a very interesting report, September 27th from Merrill Lynch, Thoughts on OFHEO's Special Examination of FNM.

They note, for instance, with regard to the derivative issue and the potential problem, the market value of these derivatives, just like that of straight fixed-rate debt, is how you correlate it with interest rates. When the rates fail, these derivatives show losses. When rates rise, they show gains. My understanding is rates are probably going to be going up in the next time period, so they are more likely to show gains than losses.

Since you have not been able to quantify this and in fact you are not clear whether this is going to be a gain or a loss, where did the request for a 30 percent increase in capital come from? How did you decide it had to be a 30 percent increase?

Mr. FALCON. It is because of the management and operations risk, as well as the uncertainty about their financials.

Mr. FRANK. But how did you calculate 30 percent? What were the figures?

Mr. FALCON. We took the 30 percent because the risk-based capital standard requires a 30 percent add-on for management and operations risk, but there is not that add-on in the minimum capital standard. We decided that given the weaknesses we found in internal controls, uncertainty of financial statements, we decided——

Mr. FRANK. And the 30 percent, you said that is the requirement. That was a preexisting figure that you decided applied here?

Mr. FALCON. That is in the statute.

Mr. FRANK. Okay. Again, I think we ought to be clear. The decision to require a 30 percent increase in capital was not based at all on any calculation on the extent to which the capital might have been impaired, but was a borrowing from the statute or an application from the statute of what happens when you find management risk.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

I would like to learn a little more about FAS 133. One of the things I want to know is whether Fannie Mae and Freddie Mac apply FAS 133 in a similar manner, or is one more conservative and more consistent than the other? Another question, as I understand it, FAS 133 went into effect in 2000 or 2001, and to qualify for hedge accounting your derivatives have to perfectly match what they are hedged against when they are booked, and you have to document that. If you do that, then you are allowed to use hedge accounting.

One of the questions I would have is, if they were not perfectly matching was it because in your findings, was it because Fannie Mae did not have the expertise or the ability to do that? Or did they and they simply decided not to for some reason? I was wondering why the auditor, KPMG, did not pick this up. This is not one of the examples that they originally cited, unless it is and I do not know it and you could let me know that.

The other question I have is, how material was this? How great were the irregularities? I know it says it has to perfectly match, but I do not know from your report the extent that this was off, and therefore requiring this long-haul accounting approach rather than the hedge accounting. Maybe you could help me out so I could better understand what is at issue here.

Mr. FALCON. Sure. On the technicalities of this 133, my chief accountant is much more qualified than I am, fortunately, to get into the details of that. She can address the difference between how Freddie Mac did it and how Fannie Mae did it.

Mr. ROYCE. Let us start with that, because I am interested if there is a considerable difference in approach. Let me just hear that out in terms of a more conservative or consistent approach by one of the GSEs over the other.

Ms. DELEO. Actually, before Freddie's restatement, the application of 133 between the two companies was substantially different. Of course now after the restatement, because of a number of things that happened during that process, they are different. You really cannot make that comparison.

Mr. ROYCE. You cannot make that comparison because they were applying a completely different approach in terms of how they were going to value the portfolio on the risk?

Ms. DELEO. I guess I would not say completely different, but substantially different.

Mr. ROYCE. Could you help me out and just indicate if initially one approach, in your view, was more conservative and more consistent than the other in terms of the two GSEs here?

Ms. DELEO. In both instances, there were misapplications. They were just mis-applied in different ways.

Mr. ROYCE. I see. Okay, well that answers my first question to some extent. Go ahead, Mr. Falcon.

Mr. FALCON. Mr. Dickerson, if you don't mind, would like to add to that, congressman.

Mr. DICKERSON. Freddie Mac had a program where they were applying their derivative hedges directly to the mortgages on their books. That was one difference. Fannie Mae has chosen to apply almost all of their derivatives to specific liabilities on their balance sheet. That is one big difference between Fannie and Freddie.

Mr. ROYCE. Okay. And let's go to the question of why the auditor, why KPMG did not pick this up. We are going back to the first year that they would have to comply. Did that auditor at the time feel they had complied with the standards that would allow hedge accounting? Or did they simply not test for that? Do we know? I would be interested in that.

Mr. FALCON. We are now looking into the determinations of KPMG on these matters. But let me make clear that the responsibility for compliance with accounting rules primarily rests with the company. It is not sufficient to simply say that the auditors signed off.

Mr. ROYCE. I understand that. I wonder, did the company at the time feel it was in compliance? I guess your argument would be, listen, if it has to match perfectly, then the company knew it was not matching perfectly by definition if they are using estimates. But I do not know the details here to know how far off they were. That is what I am trying to elicit, is a greater understanding of the specifics of this.

Ms. DELEO. Let me address that. Just backing up a second, let's talk about 133 because I think it will help in the context. One-thirty-three in principle is really a very simple pronouncement because it basically says you need to mark to market your derivatives. But it goes ahead to say that if you qualify for hedge accounting, and what we are looking at there is that you are going to go through and make an assessment test to see if the derivatives are highly effective. If they are highly effective, then you need to measure for ineffectiveness. So that is kind of the second step. If they are not highly effective, you cannot use hedge accounting.

Then in addition to that, there are some exceptions in 133, very rule-based and very specific, that say if you have matched terms, which they do not actually have, and there are very specific criteria that you must meet to do that, then in that case there is no ineffectiveness. They are perfectly effective if the terms are matched. So you would not have to do the assessment test and you would not have to measure ineffectiveness. That is the problem. It is that

they moved to that last very specific area and they simply do not qualify under that.

Mr. ROYCE. One last question. Is that because they do not in your opinion have the ability or the expertise to do that?

Ms. DELEO. They fully understood the rules. That is not in doubt. Their systems are not capable at this point of doing what we are calling long-haul accounting, doing the assessment test and the measurement of ineffectiveness. They could have built systems to do that, but that was not done.

Mr. ROYCE. I see.

Chairman BAKER. The gentleman's time has expired.

Mr. ROYCE. This really has helped me understand.

Mr. Chairman, thank you.

Chairman BAKER. I thank the gentleman.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman.

Director Falcon, I understand that your report hinges on the accounting work of Deloitte & Touche. My question is, what was your cost to retain Deloitte & Touche for the 8-month period that you said they worked for you?

Mr. FALCON. Let me clarify, congressman. This work is and the judgments in it are the product of OFHEO. Deloitte assisted us in this work and they support the findings, they agree with the findings in this report as well, but this is the work and the judgments of OFHEO. They did assist us, but I do not want to pass anything off to them. This was our judgment.

Mr. HINOJOSA. So it was your judgment, and they have signed off on the OFHEO findings. Correct?

Mr. FALCON. Yes, congressman.

Mr. HINOJOSA. You also mentioned that you did not speak to nor review the working papers of KPMG accounting firm while preparing this report. It seems to me that it is less than clear, then, that Deloitte has signed off on your OFHEO findings.

Mr. FALCON. Deloitte fully supports the findings and conclusions of this report. They also view these accounting issues as very clear-cut violations and not matters of interpretation.

Mr. HINOJOSA. Aren't the views of the KPMG auditors critical to your report? They are a very reputable firm. They do the work for my company.

Mr. FALCON. They are reputable. KPMG may disagree with us, but it is not unlike Arthur Anderson. They supported everything Freddie Mac did until that got corrected.

Mr. HINOJOSA. I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman.

Following a little bit in the line of the question the gentleman just asked, I think the one thing that has to be, from your opinion from what I have heard, it has to be pretty well-grounded would be the strength of the comment that OFHEO has made that the company willfully did misapply GAAP. Now, at the end of the day, the chairman of the SEC does make that call whether that statement will be accurate in his view. I am not saying your statement is necessarily inaccurate.

If that happens and the SEC says something, and I am not asking you to speculate on what they are going to say, but if that happens and you have said one thing and the SEC says another, is there any type of discussions? Do we have the mechanics in place in the law that allows discussions back and forth between OFHEO and SEC to say, wait a minute, we think this and SEC says that. I know the SEC is the final decision maker on it, but is there any mechanism in current law that would allow a debate or a point of view to be discussed in case there are two separate opinions?

Mr. FALCON. I think the way this would work is the SEC would determine what is appropriate for purposes of the disclosures that are filed as required by the SEC. We also rely on the financial statements of the company and its books and records in assessing the safety and soundness of the company and capital adequacy of the company.

If we see fit that the books and records are inaccurate and need to be changed for purposes of our capital requirements or for purposes of assessing their safety and soundness throughout our examination program, then we would take appropriate action utilizing our safety and soundness authority and they could do what they thought was appropriate for purposes of their disclosures that they require.

Mr. NEY. When you presented it to the Fannie Board, the fact that they willfully misapplied general accounting practice, one, what was the reaction, the statement made back to you by Fannie's board? Two, with the auditing firm, KPMG, what was their discussion with you, KPMG's, about their work papers or why they advised Fannie to do this?

Mr. FALCON. KPMG was not in the meeting with the board when we sat down with the board and presented our report to them. The board did hear the entire presentation. They were all present either in person or by telephone, and they have taken this matter very seriously. Like I said, to their credit they moved quickly to reach an agreement with us to assure that safety and soundness concerns were properly addressed.

Mr. NEY. If KPMG signed off on this and advised Fannie, and then if OFHEO has not had any discussion or your staff with KPMG as to why they advised Fannie, has Deloitte & Touche had a discussion or looked at the work papers as to why KPMG advised Fannie to do it this way?

Mr. FALCON. We are now beginning work on the process of assessing KPMG's work papers, having discussions with KPMG. In addition, just as we are bringing in the SEC into these matters surrounding financial disclosures and their adequacy, we are also speaking with the Public Company Accounting Oversight Board about the adequacy of the external auditor's work in this regard.

Mr. NEY. I just wondered on the process, and it was verging on the gentleman's question before, it seems that at some point in time Deloitte & Touche would have to have a conversation with KPMG to see why they would advise this, and look at their point of view because it is a pretty stern statement that it has been willfully misapplied. KPMG I would assume at some point in time, even though you are not to phase two of this, there would be discussions between auditing firms and yourselves to at least hear

their point of view of why they would tell Fannie, yes, this is acceptable.

Mr. FALCON. We will have those discussions. Let me ask Mr. Dickerson to talk about it. He knows more about what happened in the past and what we will do going forward.

Mr. NEY. I know you are going to have those discussions, but Deloitte is sitting there in a way, saying yes, this is misapplied general accounting practices. I just want to understand why there was not a previous conversation to give them a comfort level of why, and before this whole report came out. That is one thing I would question.

Mr. FALCON. We at OFHEO have requested work papers from KPMG and have talked with their partners about getting those work papers. We have actually received some of those work papers and have reviewed ourselves, OFHEO examiners, some of the work papers in coming to the conclusions that are in our report. It is important to note that the report represents the views of OFHEO, so it is most important for the examiners at OFHEO and the office of the chief accountant to be comfortable with what KPMG has done.

Mr. NEY. Mr. Chairman, my time has expired. At some point in time down the road, I would like to get your opinion of what tools you would need if you were to become the regulator for the future.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

I would like to ask just a few general questions about FAS 133, which obviously I am not terribly familiar with, a little bit, but not terribly familiar with. As I understand it, it is a relatively new regulation. Is that correct?

Mr. FALCON. It went into effect in 2001.

Mr. CAPUANO. So relatively new in these kinds of things. Am I right to understand that between the regulations and the guidelines and the rules relative to it, it comes to about 900 pages, give or take. Is that a fair estimate?

Mr. FALCON. Yes, Congressman.

Mr. CAPUANO. So it is a relatively new 900-page regulation.

In the normal course of events of any new accounting standards, any changes in GAAP, any changes in FAS or any of these things, am I right to understand, again, not just in banking or not just in GSEs or anyplace else, but in every day, including individuals and everything else, when something new like this comes out that is clearly long, clearly complicated, clearly important, and clearly has very important ramifications, isn't there a normal period of time in which the people who are affected by whatever the rule or regulation is, plus the auditors and the accountants who interpret it, isn't it a fairly common thing to have a period of time where people may interpret things differently, and the systems, through the industry, the regulators, the courts, the IRS, whoever it might be, the SEC, then over time tends to take different approaches to the same rule and regulation and say, well, wait a minute, we know you took different approaches, but this is not right and this is not right, and little by little they come to a consensus.

Is that not a normal situation?

Mr. FALCON. I think that grace period you are describing occurs prior to the effective date of the implementation of the rule. This rule did go through many years of discussion, many years of debate and analysis. It had a delayed effective date. Even after it was supposed to become effective, I think it was delayed for an additional year.

Mr. CAPUANO. I understand that. I understand how rules are made, but even after rules are made, are you telling me that in the normal course of events that every FAS, every GAAP rule is then implemented perfectly by everybody in lock-step with no disagreement, no discussion, no need to then clarify different things that happen in a 900-page report?

Mr. FALCON. The rules apply as of the effective date of the rule.

Mr. CAPUANO. I understand the rules apply, but how are they interpreted? You are telling me they are clear, concise and unequivocal on all counts every time there is a change in the FAS, every time there is a change in GAAP? I have to tell you, that is not my experience and I do not think that is the experience of any accountant or auditor in the country. It is not the experience of the IRS, the SEC or you.

So I understand how rules are made, but I also know that once rules are made there is still a period of time afterwards, not a set period of time, that different people read different things differently and interpret things differently with good will. So the thinking that somehow you set a rule and that is it, well, if that is the case we do not need courts. We do not need the IRS. We certainly do not need the tax court for any interpretations because we have thousands and thousands of tax rulings, and this is really just one implementation of it.

I would obviously disagree, or I am not sure that you answered the question, but clearly it takes time to work these things out.

I guess in the normal course of events, absent different issues, and not all the time, is it not a normal circumstance where many entities within the rules of GAAP, within the rules of various FAS's and other accounting procedures and tax procedures, try to on occasion smooth out earnings? Is that not something that happens here and there in the business world?

Mr. FALCON. If it happens, it is wrong. It is not proper to try to smooth out earnings by violating accounting rules.

Mr. CAPUANO. I did not say violate it. You did not hear the question. Within the rules of accounting, within the rules allowed by various regulators, there are times and certain situations that it is allowed.

Mr. FALCON. If it is within the rules of accounting, it is not improper.

Mr. CAPUANO. That is what I asked. So within the rules, the concept of smoothing out earnings in and of itself is not a violation, understanding fully well that there are times that it is wrong, there are times that it is not, and that is what the debate is about is whether these rules are right or wrong.

I also wonder, are you chasing KPMG at this point in time, or are you just kind of letting it float at the moment?

Mr. FALCON. No, we are starting, as we said, to obtain the work papers of KPMG and we will discuss with them their assessments.

Mr. CAPUANO. Okay. It strikes me again, and I know this is very complicated and I understand that, but if they had the opportunity to make these decisions, and what they did, as I understand it, and again correct me if I am wrong, is in their reports they simply cited it as an audit difference.

For those who do not understand, an audit difference does not stop the process. They could have said it was a material weakness. Nobody in their right mind wants a material weakness noted on their annual report, and hopefully even understaffed you would have found something that was cited as a material weakness in an annual report. They did not cite it as a material weakness. Am I wrong?

Mr. FALCON. No, it was just an audit difference.

Mr. CAPUANO. So then KPMG as an auditor has said, basically, look we do not necessarily agree, but it is a minor point. Here it is in the footnotes, and we will move on.

Chairman BAKER. This will have to be the gentleman's last question. His time has expired.

Mr. CAPUANO. Thank you, Mr. Chairman.

Again, I guess I will just finish by simply stating that clearly there are some serious questions. You have raised serious concerns, and if you turn out to be right, there will be some serious ramifications of it, but I still think that some of the concerns and some of the comments that have been made here today are kind of jumping the gun and putting the cart before the horse relative to allowing people to make a determination of what was right and what was wrong; what was willful and what was simply just a difference of opinion in the ordinary course of business.

Mr. TOOMEY. At this time the chair will recognize the gentlelady from New York.

Mr. KELLY. Thank you very much.

I appreciate the fact that you have delivered a partial report. It has been very interesting reading. One of the things I am troubled by and I see repeatedly in the report is that there are people carrying double roles within the structure of Fannie Mae. I understand that the OFHEO has been asking the chairman of the board and the CEO of both the GSEs to separate people into separate functions. For instance, Janet Honeywell, her job was forecasting as well as financial reporting.

There are numerous examples, starting on page 158, going on through, are people, first of all, who are not CPAs that were doing financial structuring and analysis. And secondly, they were auditing their own work essentially. My question to you is, Freddie Mac apparently has agreed to separate roles. Apparently, Fannie Mae has not. Are they in the process of working with you to try to do that? Can you talk to us about why you think this is a healthy thing to do? What is ongoing with regard to OFHEO working with Fannie Mae to make sure that there is a separation of duties?

Mr. FALCON. We do think it is important that key functions be separated so that there is not a conflict of interest or that someone with an incentive to meet some goals also has the ability to manage the accounting of those goals such that they are met.

So we have taken action, going to Freddie Mac to make sure there was proper separation of offices and functions and individual

responsibilities. The board of Fannie Mae has agreed with us to create a separate chief risk officer. We found that the individual responsible for setting goals in this instance was also responsible for making sure that they were met.

We are looking at other issues as well. We have a pending corporate governance rule amendment which would separate the function of the chairman of the board and the chief executive officer. Freddie Mac has already agreed to do that, and once this rule is implemented it will also provide the same for Fannie Mae.

Mr. KELLY. I want to go back to page 160 of your report. I do not know how to pronounce Sam Rajappa. I do not know how to pronounce that last name.

Mr. FALCON. That would be Rajappa.

Mr. KELLY. It is Rajappa. Thank you. There is a statement in here by Tim Howard noting that Sam Rajappa reports directly to the chairman of the audit committee, but for the last I think year and a half, maybe 2 years, he has reported on a dotted line basis to me.

In reading your report, I could not quite figure out who had a straight firm line and who had a dotted line, because it looked to me like a lot of these things were being mixed responsibilities. Jeffrey Guliana had a dual responsibility. There is one name after another here where I do not see a solid structure, but rather an informal structure. I would like you to expand on what you have found with regard to this, because I am not sure exactly who was the person that was signing off on the bottom line here.

Mr. FALCON. That is a good question. We found that this was a big weakness in the way these accounting policies were being set. There was not a clear process in place. There were no accounting controls. There was not even adequate documentation about what the accounting policies were and the roles in formulating these accounting policies.

Let me ask Mr. Dickerson, who can speak very well to these internal control issues, to elaborate further.

Mr. DICKERSON. Right. We found, for example, in the amortization area that there was one individual who was in charge of the modeling and accounting for amortization. That is a weak segregation of duties. We found, you mentioned Ms. Pennewell, who was in charge of financial reporting and financial planning, so she had opportunities at least to help meet through accounting financial goals that her group had earlier set.

Mr. KELLY. Is there now in place a structure, because I understand from Mr. Falcon, from what he just said, that that structure has not really been changed much, and it is still unclear to me. Have you established with them now a clear line of who reports to whom?

Mr. FALCON. It will take a little time to fix all of these problems, to do the reorganization within the company and create the positions and select individuals for the positions. But this is something covered by the agreement with the board, and we are going to move as expeditiously as possible to get these fixes in place.

Mr. KELLY. Thank you.

Chairman BAKER. The gentlelady yields back.

Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman.

I was late in the hearing, but I do want to thank you for coming here today and helping the committee with its work. I know you have had a rough time with some of my colleagues, but I do not think there is anybody here that questions your good intentions to help us with this process. That is the position I take. You are good to do your work and we need you to do it really well, and I am sure that is going to happen.

However, this is the political side of the table, so some of us up here are going to twist and use your information to help us grind an axe with Fannie Mae or others, or to defend it as I will intend to do. But that is not to discount the good work that you are doing.

I do want to rebut a couple of things, and I want you to work with me here. I have heard Enron, Enron, Enron a bunch of times here. Quite frankly, the chairman of the subcommittee did a wonderful job in helping the committee with its work in that case, but even the chairman of the full committee has brought that specter to bear in comparing what has happened at Fannie Mae to Enron.

I just want to ask you, we had the Enron situation. We had a house of cards there, a financial house of cards where there was no strength to the underlying business. They had a very unsound business model. We had serious problems in the underlying business. Is that what you see here? Is that what you see here?

Mr. FALCON. The business model of the company remains sound.

Mr. LYNCH. Remains sound.

I do not have much time. That is just one thing I wanted to get out there.

Mr. FALCON. Okay.

Mr. LYNCH. We had 19 criminal indictments. We had 96 criminal charges. We had 78 fraud counts against the people who were running Enron. Is that what we have here? Or is it more in the line of noncompliance with accounting standards?

Mr. FALCON. We have deferred any opinions, resolutions of any criminal conduct to the Justice Department. We have referred to the corporate fraud task force our report. We are cooperating, giving information to the U.S. attorney upon request about anything we found and documents that we have about this. Beyond that, we are not forming judgments about the criminality of this, and we have not made any criminal referrals to the Justice Department.

Mr. LYNCH. Thank you. In terms of the gross manipulation that occurred in the California power market by Enron in which investors and employees lost their pensions and their life savings. Is that what we are looking at here or is it something different?

Mr. FALCON. I think until the entire review is over, I would withhold maybe broad categorical statements about this. Certainly, what we have found to date raises serious concerns with us about the company's proper accounting, as well as their internal controls, doubts about safety and soundness, prior financial statements. If we find that this type of conduct shows up in other areas that we have yet to begin to review, then it would become much more serious than even it is now.

Mr. LYNCH. So you are saying they could be defrauding the public and the investors and the employees just like Enron? Is that what you are saying, that this could be one of those cases?

Mr. FALCON. No. I do not know. I have no——

Mr. LYNCH. You just said there was a sound business model here.

Mr. FALCON. Exactly, a sound economic business model. But as far as any criminal intent or any desire to break laws for some criminal purpose, I do not know. I cannot speak to that.

Mr. LYNCH. Okay. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Toomey?

Mr. TOOMEY. Thank you, Mr. Chairman.

What I would like to do is address this question of whether we are really talking about a difference of interpretations of ambiguous rules, or whether we have something that is really pretty objective. While this gets a little bit complicated, I think it is manageable, I hope within 5 minutes. Let me see if I can walk through what I understand to have gone wrong with respect to FAS 91. Tell me where I go wrong on this.

First of all, Fannie Mae buys assets that trade at premiums and discounts. Correct? Some of these assets have prepayment features.

Chairman BAKER. Mr. Toomey, I hate to interrupt your train, but I will let you re-start.

Just by way of announcement for members, I understand we will have a series of two votes. It would be the chair's intention upon recessing for those two votes that we would recess the committee for 30 minutes to give members and witnesses a chance to refresh themselves. That would mean we would return here, let's just say 1:30 p.m. We would proceed with Mr. Toomey's comments and questions, and then break at that point, just so all members are advised, 1:30 p.m.

If you would like, you can proceed now, or at your leisure; if you want to come back. Either way.

Mr. TOOMEY. I would like to proceed when we get back.

Chairman BAKER. Okay. Great. The committee will stand in recess until 1:30 p.m.

[Recess.]

Chairman BAKER. At this time I would like to reconvene the hearing of the Capital Markets Subcommittee.

At the time the committee recessed, Mr. Toomey had been recognized to proceed, and at this time I recognize the gentleman for 5 minutes.

Mr. TOOMEY. Thank you, Mr. Chairman.

I would like to take up where we left off on this discussion about whether what we have seen with Fannie Mae has been a willful misrepresentation of certain income and expense accounts, or whether it is just the difference in interpretation of an inherently complex and ambiguous accounting laws.

It seems to me the allegations being made by OFHEO, which frankly seem very well substantiated, are very clear: It is the former. This is a willful, conscious misrepresentation.

And in fact, KPMG agrees with you and not with the company when they cite this irreconciled item. Is that correct?

Mr. FALCON. Yes, the $200 million——

Mr. TOOMEY. The $200 million—number one, their auditors agree with you, not with the company, with respect to this treatment.

Now, I would like to get to the substance of what this treatment is about with regard to FAS 91.

As I understand it—and please correct me when I go wrong here—my understanding is that when a financial services firm such as Fannie Mae buys assets at either premiums or discounts, some of which have prepayment features, they are required to amortize the premiums and the discounts over a projected life of the asset, which is determined in part by estimating prepayment rates and other things.

My question for you is: When those assumptions are made, the model is employed and an amortization schedule for premium or discount is arrived at, is that not a very precise figure?

Mr. FALCON. Yes.

Mr. TOOMEY. So it is not a range, it is not a ballpark, there is a number. And if you carry it out far enough it goes right to the penny. Is that correct?

Mr. FALCON. Yes, Congressman.

Mr. TOOMEY. And then my understanding further is that when the next quarter comes around, interest rates very often will be different than what was projected in the previous quarter, and that requires a reassessment.

And part of that reassessment is a very precise—it is a new number, and the company is required to catch up, if you will, on the previous errors that come to light, errors with respect to how reality differed from what was projected in the previous quarter. Is that correct?

Mr. FALCON. Yes. We are required to make those adjustments. I would not use the term "catch up" in the same sense that the company called what they were doing a catch-up.

Mr. TOOMEY. Okay, but they are required to make an adjustment, to affect the cumulative difference between what was projected and what in fact occurred in economic reality, and that, too, is a very precise number. Is that correct?

Mr. FALCON. Yes.

Mr. TOOMEY. And the rules, do they say that despite the fact that a precise number is calculated, you do not have to really use that number? Does FAS 91 give any discretion about what number you use?

Mr. FALCON. Let me ask our chief accountant.

Ms. DELEO. No.

Mr. TOOMEY. It does not. Does FAS 91 suggest that you can round this number to some degree?

Ms. DELEO. No.

Mr. TOOMEY. Okay, it does not allow that.

I am looking the testimony from Mr. Raines and from Mr. Howard, and it talks about how this estimation process is imprecise. In fact, it is not imprecise at all; it is very precise.

It is subject to future revision, but at the point in time in which it is calculated, it is perfectly precise. Is that correct?

Ms. DELEO. That is correct.

Mr. TOOMEY. The alleged imprecisions are used in Mr. Raines's testimony as a justification for creating a range. In fact, the range has nothing to do with this calculation. Or does it?

Ms. DELEO. No, the range does not have anything to do with it.

Mr. TOOMEY. The range was a perfectly arbitrary invention of the company, it seems to me. Is that your opinion?

Ms. DELEO. Correct.

Mr. TOOMEY. And the range of $100 million, plus or minus, from these adjustments is not even contemplated, much less allowed, under FAS 91, is it?

Ms. DELEO. There is nothing under FAS 91 that would allow for a range.

Mr. TOOMEY. So it is not as though there is a range that is allowed and there is a dispute over how much. There is no such concept.

But you make a further allegation, if I understand it correctly, which is that not only is it simply and very straightforwardly wrong to not report the full number precisely as calculated, which Fannie Mae has done, but that there was a policy within company systematically not to report the precise number, but rather to have this cushion that you describe as a cookie jar, which served the purpose of evening out income. Am I correct to understand that?

Ms. DELEO. You are correct.

Mr. TOOMEY. Some seem to suggest that this is not really material, you know, Fannie Mae is a big company, you know, it has got a lot of income. But this range that they created was $100 million. Right?

Ms. DELEO. Plus or minus 1 percent, but it basically rounds to $100 million.

Mr. TOOMEY. And it was not an effort to round this number; it was derived from a totally different set of calculations regarding total—my time has expired. I just want to make the point.

A plus or minus variation here of $l00 million, what does Fannie Mae roughly earn in a quarter? What is the total income in a quarter?

Mr. DICKERSON. Probably in the neighborhood of a billion.

Mr. TOOMEY. About a billion.

Chairman BAKER. I would say $150 million, probably.

Mr. TOOMEY. So we are talking over 10 percent of the reported income in a given quarter.

Mr. DICKERSON. Actually it could work out larger than that.

Mr. TOOMEY. And it could work out larger than that.

So by virtue of the sheer magnitude, I do not understand how someone can say it is material.

But I would further argue that I am not sure the materiality applies as a concept when you are dealing with a systematic misrepresentation of the numbers. I do not think that is allowed regardless of how big the misrepresentations are. Is that correct?

Ms. DELEO. I would completely agree with that.

Chairman BAKER. Your time is expired. It has been most helpful. I appreciate your insights, Mr. Toomey.

Mr. Meeks?

Mr. MEEKS. Thanks, Mr. Chairman.

Let me make sure—I think that it has put some things in context, especially with reference to some of the process.

I think it is a matter of fact, I think you would agree with me that plenty of people do not like Fannie Maes or Freddie Macs for that reason, their current status in the market. People wanted to change it.

Before your report came out there was talk from this committee and from others in the private company that one did not like the status that Fannie Mae had. You would agree with that—right?—the status that Fannie Mae and Freddie Mac currently has in the market?

Mr. FALCON. No, Congressman, I do not support privatization of these companies.

Mr. MEEKS. I did not ask you that. I did not ask you whether you do or not.

I said I think that we could all agree that we know from either some of your prior testimony, there are individuals in some movements that have been afoot that did not like the status of Fannie Mae and Freddie Mac had within the market. You could agree with that.

Mr. FALCON. Only certain individuals——

Mr. MEEKS. And is it also true that in fact you, when you came here previously to testify on other occasions, many individuals on this committee were very critical of you and challenged your ability to be able to relate to the largest financial entities in this country. Is that not correct?

Mr. FALCON. Yes, Congressman.

Mr. MEEKS. In fact, they were so upset with you at that particular time, there were bells put forward that indicated that they may need to create a new regulator for the GSEs. Is that not also correct?

Mr. FALCON. Yes.

Mr. MEEKS. And it is also true that this is a special examination, a special examination actually departed from what is standard financial institutional examination procedures. Is that not also correct?

Mr. FALCON. No.

Mr. MEEKS. This was not a special examination?

Mr. FALCON. Yes, it was a special examination, yes.

Mr. MEEKS. All right. And under ordinary procedures, would it not also be a situation whereas, you know, there were questions in regards to some of the regulations that you were overseeing that Fannie Mae, or whoever you are investigating, would have had the opportunity to address those issues prior to the issuance of the report.

Mr. FALCON. Any examination follows a pattern where if it is a normal examination, like our annual risk-based examination, there will be, depending on severity of the issues that are found, you could have, would have give and take between the management.

But this was a special examination, or it was situation where there were serious concerns raised about the conduct of management in this area of accounting and internal controls——

Mr. MEEKS. And some of that is subjective. Because as we indicated, I think that when someone was talking before, the person

that is clearly talking about FAS 133F and FAS 91, the ultimate determination is going to be made by the SEC, and there could be a question whether discretion, whether or not—because we do not know, you know, it could be a difference of opinion between you and the SEC. We do not know that yet.

Right now what you are putting out is just more allegations.

And what I am talking about, when I start talking some irregularities, I am talking about—well, you know, even Senator Bond talked about the leaking of evidence or leaking of letters to the Wall Street Journal, other press. That is not standard. That does not happen under those circumstances. Is that a common procedure, to leak evidence and letters?

Mr. FALCON. Congressman, we did not release this report prior to the board agreeing with us that they did not have any objections to this report being put into the public domain. I received a letter from members of Congress in fact urging me to do so.

I had a commitment to the board not to release this report while we in these discussions. But once they no longer objected, I decided to do so.

Mr. MEEKS. But even before they objected, things were leaking out. And I do not know if Congress had ever asked for it, but things were leaking out before—at one time and previously.

So it has not been the usual type of investigation here, with things leaking, to give a hint of something or other. It seems to me that it is just curious to me that this is happening.

Well, OFHEO itself was threatened with reference to being replaced by a regulatory agency.

But let me just go to someplace else, because you make strong allegations. And, you know, sometimes you throw things out there. I know, I used to be a prosecutor. And it is very dangerous. And you made some allegations, strong allegations, that, you know, I do not know where the evidence—I have not heard the evidence of it.

But, again, coming from the background that we are talking about, with reference to the pressure that was put on OFHEO by others and members of this committee about doing certain things, and all of a sudden I see this report coming out, I see things that are being leaked out.

And then you make some charges that a lot of this is being done because of executive bonuses. That is a very serious charge. And I don't know exactly how you back this up. Can you just tell me? How do you back this up?

Mr. FALCON. It is our judgment, based on the evidence we saw, that this company in 1998, in that instance, when you look at the circumstances, the company deferred this $200 million of expenses in disagreement with this external auditor, and the evidence seemed to us that it was in order to meet these compensation bonus targets.

Chairman BAKER. The gentleman's time is expired. Did you have a wrap-up?

I thank the gentleman.

Mr. Bachus?

Mr. BACHUS. Thank you.

Director, derivatives have been used to hedge risk and actually have been used successfully. In this case, you have talked about

this particular derivative contract had not been approved for hedging. Is that right?

Mr. FALCON. Their derivatives portfolio, they were classifying all but about $43 million of the notional value of their derivatives portfolio as eligible for hedge-accounting treatment, which means any changes in market value would flow through other comprehensive income and not through the——

Mr. BACHUS. To flow to the——

Mr. FALCON. Yes.

Mr. BACHUS.——to the underlining security of whatever it was hedged to, whatever the derivative was based on?

Mr. FALCON. Whatever change in value occurred in the derivative wouldn't flow through earnings to the balance sheet, but rather would go through other comprehensive income.

Mr. BACHUS. Okay. Did that affect Fannie Mae from a safety and soundness standpoint, in your opinion?

Mr. FALCON. I think, overall, everything we find in this report does raise concerns about the company's safety and soundness. We have found practices that are inconsistent with safety and soundness, practices about not complying with accounting rules, not having accurate financial disclosures, not having the appropriate internal controls.

The report has great detail, I believe, on the reasons why we have expressed concerns about the company's safety and soundness.

Mr. BACHUS. Just assuming that they had applied with the FAS 133 in their risk management, do you believe that Fannie overall has made the right economic and risk management decisions in terms of protecting its portfolio from market risk?

Mr. FALCON. They use their derivatives to hedge against the interest rate risk associated with this retained portfolio that they manage. And their use of these derivatives is proper to hedge risk. We are not questioning their use of derivatives to properly manage the interest rate risk that they face.

What we are seeing here is a lack of compliance with the accounting rules. We are also looking at other things related to this derivatives portfolio. This is just the beginning of what we have determined. These are our findings to date. And we will continue to look at issues raised.

They use—their policy is to use derivatives only to hedge risk and not to speculate. That is also our safety and soundness standard.

Mr. BACHUS. How long——

Mr. FALCON. But we are looking at it to make sure there weren't transactions that were inconsistent with that policy.

Mr. BACHUS. Okay. How long—I mean, you have been critical of their internal controls and of some of their accounting practices. How long have these practices been going on and these lack of internal controls, in your opinion?

Mr. FALCON. The internal controls—I guess we found that—the policies on FAS 91 date back to 1998 and on 133 date back to 2001. So certainly these weaknesses that allowed these improper accounting policies to be put in place certainly go back as far as that.

Mr. BACHUS. Now, you are examining them on a regular and constant basis, right?

Mr. FALCON. Yes.

Mr. BACHUS. Why did you just now discover those things? Why did it take this long?

Mr. FALCON. We look at many issues related to credit risk, interest rate risk, management and operations risk, a wide variety of areas of a company's risk profile.

This is an area where, very recently, as a result of the Freddie Mac accounting problems, we decided to go and take a very close, detailed look at Fannie Mae. We have not, prior to this point, conducted such an in-depth examination focused on one area of the company.

Our examination program assesses their risk and risk-management practices across a wide range of risk. Focusing in narrowly on this subject has uncovered problems that the broader review has not uncovered previously.

Mr. BACHUS. Okay. One final. Did you all consult with—now, KMPG was their outside auditor, right?

Mr. FALCON. Yes.

Mr. BACHUS. And Deloitte & Touche, you all used them to do your audit, right?

Mr. FALCON. Yes.

Mr. BACHUS. Is that right? Have you all consulted with KMPG about your findings?

Mr. FALCON. We have begun the process of obtaining KPMG's work papers, discussing this with KPMG. But we have not gone down a path of trying to—management and the company is ultimately responsible for ensuring that the company's policies and practices in the accounting area are consistent with GAAP.

Mr. BACHUS. But you were totally unaware that they were doing all this until just recently?

Mr. FALCON. We have not conducted an in-depth accounting exam like this previously.

Mr. BACHUS. Had you criticized their internal controls prior to this? You are their regulator, right? And internal controls would be a basic part of—for instance, who signs off, who within the company signs off on these derivative contracts and their treatment? Had you questioned those in the past?

Mr. FALCON. I would have to go back and look at our previous examination reports. But if we did, in fact, identify these problems in the past, we hadn't conducted this type of an in-depth examination before.

Mr. BACHUS. You probably should have, right?

Mr. FALCON. I would have liked to have done it previously, yes, now that we know what we know.

Chairman BAKER. One more question, sir.

Mr. BACHUS. On September the 20th, you were meeting with the Fannie Mae board. You all were going to present to them your findings, is that correct?

Mr. FALCON. Yes.

Mr. BACHUS. And you had not made that known to the public at that time, had you?

Mr. FALCON. Right.

Mr. BACHUS. And I know everybody was waiting on that meeting. And then that morning I recall picking up The Wall Street Journal and seeing it pretty much laid out as to what you all's report was going to show in detail. That is a violation of your own rules, isn't it?

Mr. FALCON. Right. We did not authorize—I did not authorize the release of any information about what we were about to do at the board. All I can tell you is, the Friday before that Monday, we did bring some other federal agencies in the process in an effort at interagency cooperation to let them know what we had found and what we were about to do. Now, that Friday we had also had discussions with some board members, in order to get them to convene the meeting for Monday.

Mr. BACHUS. But somebody disclosed what was then nonpublic information. I know that is a violation of you all's guidelines and every agency's. I think your guideline 105 prohibits the disclosure of nonpublic information regarding a regulated entity and actually provides civil and criminal penalties. So somebody would have had to violate that guideline, would they not?

Mr. FALCON. If it was someone in the company, within the agency——

Mr. BACHUS. Or in another agency, then they would have——

Mr. FALCON. Well, our guideline only applies to us. If you are citing our guideline, it only applies to OFHEO and not——

Mr. BACHUS. Have you done anything to identify—or, were you concerned about that, when you saw that that nonpublic information had been disclosed in violation of your own rules and regulations?

Mr. FALCON. I am always concerned about information that shows up in the public domain——

Mr. BACHUS. Have you all tried to identify the individual or individuals who violated these rules?

Mr. FALCON. I am not sure, Congressman, what shows up in the newspaper, whether it is conjecture, speculation. There is an insatiable rumor mill that circulates around everything——

Mr. BACHUS. Actually, it was specific in what they——

Mr. FALCON. It is hard for me to discern what is speculation and what is based on a leak and what is based on some authorized release of information.

Mr. BACHUS. You saw that report. It was pretty apparent that they had to have inside information.

Mr. FALCON. I have seen speculation about what we might do for months and months now, based on what knowledge people had about what we did with Freddie Mac.

Mr. BACHUS. Okay.

Chairman BAKER. Mr. Bachus, you have used almost twice your time. You are, like, 5 minutes over.

Mr. BACHUS. I am sorry.

Mr. FRANK. And you are not going to get an answer, no matter how you ask, so you might as well move on.

[Laughter.]

Chairman BAKER. Let us see, Mr. Watt, I think you are next.

Ms. Waters is next?

Okay. Ms. Waters?

Ms. WATERS. Thank you very much, Mr. Baker.

Mr. Falcon, you have been before this committee before. And you were pretty much on the hot seat on more than one occasion, where you were accused of not doing a good job, not exercising your oversight responsibility, of being incompetent.

And I think a number of members you talk with following those hearings, where you not only ask for support but try to make the case why OFHEO should remain. Is that true?

Mr. FALCON. No, I have actually supported a regulator with all the authorities and powers and resources to do his job, even if it means abolishing my agency.

Ms. WATERS. Did you seek support for yourself and for your agency following the criticism that was reaped upon you in this committee? Did you talk to any members of Congress?

Mr. FALCON. Oh, yes, I have——

Ms. WATERS. All right, thank you.

I would also like to know a little bit more about what has happened since the time that you came under such criticism and how you got to this point. You talked about when you first decided that you were going to do this investigation on Fannie Mae.

Did you at any time talk with any members of Congress during the time of this investigation about what you were doing, seek any advice, get any suggestions, any members or their staffs? You are under oath.

Mr. FALCON. I recall questions from various members of Congress in the Senate who——

Ms. WATERS. Did you talk to any members of Congress or their staffs about this investigation, seeking advice, getting advice, accepting suggestions, hearing suggestions about this investigation?

Mr. FALCON. Asking advice about—not for the purposes of trying to get advice from a member of Congress about what we should look at——

Ms. WATERS. So you did talk with some members of Congress or their staffs while you were in the process of this investigation. Is that correct?

Mr. FALCON. Yes.

Ms. WATERS. All right. Did any member of Congress or their staff offer support for OFHEO or you in exchange for suggestions or give you ideas about how you ought to approach this investigation?

Mr. FALCON. Absolutely not.

Ms. WATERS. Did you report to the chairman of this committee, this subcommittee, or the chairman of the overall committee or the ranking member of this committee at any time during this investigation about what you were doing?

Mr. FALCON. Absolutely not.

Ms. WATERS. Let me go one by one.

Did you, at any time, report to the chairman of this entire committee, Mr. Oxley, about what you were doing?

Mr. FALCON. About the—no. But——

Ms. WATERS. About the investigation, anything that you were doing or undertaking in the investigation.

Mr. FALCON. No.

Ms. WATERS. Did you, at any time, talk with Mr. Baker about whatever was going on in the investigation? Did you seek advice,

did you get any advice, did you have any conversations with him about the investigation?

Mr. FALCON. I have not sought any advice, any guidance about how to—from any member of Congress——

Ms. WATERS. Did you talk with Mr. Baker——

Mr. FALCON. No.

Ms. WATERS.—about the investigation at any time or his staff?

Mr. FALCON. No. It would have been improper for me——

Ms. WATERS. That is all I want to know. Did you talk with Mr. Baker or his staff at any time during this investigation in any shape, form or fashion, whether it was seeking advice, just hearing advice, advising about what you were doing? That is all I want to know. Did you? Yes or no?

Mr. FALCON. Let me answer the question. I did speak to several members of Congress about the investigation, about the need for funding for the investigation——

Ms. WATERS. But I specifically asked about Mr. Baker at this point.

Mr. FALCON. Oh, Mr. Baker, yes, and other members of Congress——

Ms. WATERS. All right. Thank you.

Mr. FALCON.——including other senior members of the committee about the investigation and my need for resources to keep this thing going.

Mr. FRANK. Would the gentlewoman yield?

Ms. WATERS. Yes, I will yield to the gentleman from Massachusetts.

Mr. FRANK. I just want to make clear that I was never told or any way informed. My understanding was the Republican leadership was informed before this broke that this was about to break. But I want to make it clear: No one on the Democratic side received any notice. And I do believe there was, unfortunately, notice on the Republican side in advance.

Ms. WATERS. Taking back my time, this is not simply about notifying about this hearing. This is about what was going on in the investigation, how it was being approached, what was being done.

Were you talked to at any time?

Mr. FRANK. No. As I said, I didn't even get the notice that others got that it was happening, and so we had never heard anything.

Ms. WATERS. Okay. Then that is well made.

Now, did you discuss the 30 percent reserve with any members of Congress and get a suggestion about that amount prior to concluding that that was the amount that should be in reserve?

Mr. FALCON. No.

Ms. WATERS. Did you talk with any staff member?

Mr. FALCON. No.

Ms. WATERS. This, again, based on the questioning of Mr. Barney Frank, was an amount that you came up with but that amount was not based on any calculations, any research that would indicate that this would be the proper amount in reserve. You did not have any supporting documentation for that, is that correct?

Mr. FALCON. We arrived at the 30 percent requirement because we thought that was prudent from a safety and soundness stand-

point, given the weaknesses in management and operations, given the uncertainties of the financial statements——

Ms. WATERS. I am asking about your documentation. Did you pull it out of the thin air? Did you pull it out of air? Did you have some documentation? Did you have something to compare it with? How did you get the 30 percent?

Chairman BAKER. And that would need to be the—if I may, that would need to be the lady's last series of questions.

If you would respond, because the gentlelady has exceeded her time significantly. Would you please respond to the gentlelady's question?

Mr. FALCON. Congresswoman, we based—I based that decision, using my judgment about what was appropriate, prudential in order to ensure the safety and soundness of this company. Given the uncertainties about their balance sheets, given the operational weaknesses, there was precedent for this with Freddie Mac, I took action that I thought was essential to make sure that this company, that its safety and soundness was ensured.

And we arrived at 30 percent because there is a 30 percent management and operations risk in the statute for risk-based capital, so we simply applied the same standard to the minimum capital.

Ms. WATERS. You had no documentation.

Thank you. I yield back the balance of my time.

Chairman BAKER. Mr. Watt?

Mr. WATT. Mr. Chairman, Mr. Davis from Alabama has a bill on the floor and I would like to defer to him, if it is okay.

Chairman BAKER. Oh, I am sorry, Mr. Manzullo, you have been patiently waiting.

I should go to Mr. Manzullo first, and then I will come back to Mr. Davis.

Mr. MANZULLO. Thank you.

I am reading page 11 about the actual amount of the bonuses. Mr. Johnson got a $1.9 million bonus on a salary of $966,000; Mr. Raines, $1.1 million bonus on a $526,000 salary; Lawrence Small, $1.1 million on a salary of $783,000; Jamie Gorelick, $779,000 bonus on a salary of $567,000; Timothy Howard, $493,000 on a salary of $395,000; and Robert Levin, $493,000 bonus on a $395,000 salary.

These are annual bonuses. Is that not correct? Every year they have a bonus?

Mr. FALCON. Yes.

Mr. MANZULLO. And so this is what they make. This is just for 1998. Is that correct?

Mr. FALCON. That was the amount of the AIP award and bonus.

Mr. MANZULLO. What you see on page 11 is nothing less than staggering. Because you state that the earnings-per-share range, the minimum payout is $3.13, the maximum was $3.23, with a target of $3.18.

And just by happenstance, coincidence, you could almost say on your terms that for Fannie Mae to pay out the maximum amount in annual incentive payment awards in 1998, the earnings per share would have to be $3.23. It is below the $3.13 minimum payouts threshold, no bonus would occur.

And then you state, remarkably, the 1998 earnings-per-share number turned out to be $3.23 and nine mills, a result that Fannie Mae met the EPS maximum payout goal right down to the penny, and that if they had used the correct accounting practices—which you say in your testimony, accounting violations cannot be dismissed as mere differences of interpretation, Fannie Mae understood the rules and simply chose not to follow them, but if Fannie had followed the practices, there would not have been a bonus that year. Is that not correct?

Mr. FALCON. That is right, Congressman.

Mr. MANZULLO. Well, what are you saying here? Are you saying this is coincidence? Or did somebody cook the books to come up with $3.23 and nine mills so they got the maximum payment.

Mr. FALCON. I think what we are saying is, there are very strong appearances that the management did, in this instance, improperly defer $200 million of this $400 million expense to the next year for the purposes of achieving these bonus targets.

Mr. MANZULLO. So the main purpose was so they could get their bonuses. That is what you just said.

Mr. FALCON. Yes, in addition to the appearances of smoothing earnings.

Like I said, this was the beginning of the implementation of their catch-up in their FAS 91 accounting policies which allowed them to utilize this amount to project smooth earnings over time.

Mr. MANZULLO. I find this staggering. This is absolutely astonishing when the oversight organization says that Fannie Mae projected its earnings and did its accounting practices for the reason so that the executives could get the maximum amount of their bonus. That is your conclusion?

Mr. FALCON. That certainly how it appears to us, yes.

Mr. MANZULLO. And did you look at bonuses for any other years besides 1998?

Mr. FALCON. We have information about the bonuses for the years—yes, and it actually included the information that was given to Chairman Baker.

Mr. MANZULLO. Can you tell us what the bonuses were for subsequent years to 1998?

Mr. FALCON. I believe for the top five individuals, it is a matter of public record because of the disclosures under the securities laws.

Mr. MANZULLO. Were they similar amounts, do you recall offhand?

Mr. FALCON. I believe they were similar, yes.

Mr. MANZULLO. Did your research, investigation, look at any other years besides 1998 to see if you came up with similar conclusions?

Mr. FALCON. We have not to date, I believe, found a transaction like the one in 1998, which was deferred to another year with the fact of resulting in full bonuses as opposed to no bonuses.

We have not yet found a similar type transaction in similar years, in subsequent years, but we certainly do see the fact that the policy of managing their earnings occurred over time at the same that their Challenge Grant Initiative was put forward.

Mr. MANZULLO. So this is all based upon the fact that you are paid according to the—you get your bonus according to the earnings per share, regardless how you get those.

Mr. FALCON. That is the metric that is contained in their compensation program.

Chairman BAKER. Mr. Manzullo, you have expired your time, but you have one wrap-up.

Mr. MANZULLO. I do have one final question that speaks for itself.

I believe on page 12 that says that if they had done the correct accounting method there would not have been a bonus that year.

Mr. FALCON. Yes, that is right.

Mr. MANZULLO. Thank you.

Chairman BAKER. I thank the gentlemen.

Mr. Davis?

Mr. DAVIS. Thank you, Mr. Chairman.

Let me thank my friend from North Carolina for yielding.

Mr. Falcon, when Mr. Lynch was questioning you earlier, you said something that really caught my attention. You said that you wanted to avoid making any broad and categorical statements until the investigative process was complete.

Do you remember saying that?

Mr. FALCON. Yes.

Mr. DAVIS. That sounds like a good goal, and I think that is exactly the stance that one would want from someone in your position.

So in light of that, let me ask you about several observations that you have made and see if they meet the standard that you set out.

Mr. Manzullo asked you a number of questions and others have asked you questions about the motivation for the expenses, and you said fairly directly that you think that the motivation was to pave the way for bonuses, or to create an appearance of earnings to justify bonuses.

Is that not a pretty broad and categorical statement on your part?

Mr. FALCON. It is.

Mr. DAVIS. And second of all—if I can continue, as my time is limited—you made the observation or response to someone's questions—where you were asked rather point blank: Would it be in the interest of Fannie Mae if there was a change in the management structure?

Do you recall those questions?

Mr. FALCON. Would it be in the interest——

Mr. DAVIS. You asked if it would be in the interest of Fannie Mae if there were a change in the management structure.

Mr. FALCON. Yes, we had that.

Mr. DAVIS. And I think your answer was in the affirmative that it would be. Do you recall that?

Mr. FALCON. I think what I said was, we were going to assess—that the question before us was whether or not we had sufficient confidence in this management team going forward, trust that they could properly implement this plan of remediation and have the confidence of both us and the board going forward to properly run this company in compliance with all the rules and regulations.

Mr. DAVIS. You had various questions about the management structure.

Mr. FALCON. Yes, yes, I did.

Mr. DAVIS. Is that not a pretty broad and categorical statement to raise questions about the management structure?

Mr. FALCON. It is.

Mr. DAVIS. Furthermore, you make a pretty broad statement in your report—in fact, I think I am quoting from you—that there was a pervasive and willful misapplication of GAAP in two critical areas.

Is that a quotation from your report?

Mr. FALCON. Yes.

Mr. DAVIS. Is the reference to a pervasive and willful misapplication a pretty broad and categorical statement?

Mr. FALCON. It is, about these two accounting areas.

Mr. DAVIS. So let me put this in perspective, because I agree with your honesty in all four of those answers, those are very broad statements.

One of the things that has been raised by several of my colleagues on this side of the aisle has to do with: As I would characterize it, does OFHEO have the appropriate level of arms-length relationship that is needed with Fannie Mae?

Several of my colleagues have made the point, and I make the point to you now, that as I understand the mission of OFHEO, it is to be a regulator, it is to assess the safety and soundness of the institution that you are regulating.

The SEC has the responsibility of making judgments about whether accounting fraud occurred.

This body has the responsibility of making judgments about the proper policy course.

And the Justice Department has the responsibility of making proper judgments about whether a criminal act has happened.

Have I gotten the division of labor just about right, from what you know?

Mr. FALCON. There is some overlap——

Mr. DAVIS. There is some overlap, but do I basically have it right?

Mr. FALCON. Yes.

Mr. DAVIS. A concern that I have—and I want to give you a chance to respond to it—but a concern that I have is you are making very specific, what you have correctly acknowledged, broad and categorical judgment about the management of this institution, about the willfulness of practices that may or may not be in controversy.

You have imputed various motives to the people running the organization.

You went to the board and put a 48-hour ultimatum on them without having any specific regulatory authority to put that kind of ultimatum on them.

That sounds like some kind of an invisible line has been crossed. That sounds to me as if you have gone from being a dispassionate regulator to someone who is very much involved and has a stake in this controversy.

And I will follow up on Ms. Waters's point because I think it is very well taken: Her observation is that the political context surrounding your investigation was that serious doubts were being raised about OFHEO.

In fact, frankly, doubts were raised about your leadership of OFHEO. And all of a sudden, the response to that is to produce an enormously critical report.

My concern is that OFHEO has jumped off the fence—where it should be, if it is a dispassionate regulator—and has somehow gotten involved in the business of taking a side in this controversy.

Now, I will give you a chance to respond to that.

Mr. FALCON. Well, Congressman, I appreciate the time to respond.

The categorical statements that I was referencing to with Mr. Lynch was, he asked me to make a broad categorical statement as to whether or not we had Enron-like fraud going on with this company.

Mr. DAVIS. No, sir. You said that you had a problem with making broad and categorical statements. And your instinct is right.

The reason—and I will make this my last point—the reason that you do not want to make broad and categorical statements I suspect is because the ultimate concern of OFHEO ought to be the safety and soundness of Fannie Mae.

Is it possible that by casting all of these dispersions and all of these doubts upon the board at Fannie Mae, and upon the structure of Fannie Mae, that you potentially are weakening this institution in the market, that you are potentially weakening the housing market in this country?

Are those possible consequences from the very broad and sweeping generalizations you have made about this institution?

Mr. FALCON. Well, first off, we may disagree on this, but it was not what I was telling the congressman about the type of categorical statements——

Mr. DAVIS. No, please answer the last question that I asked you.

Chairman BAKER. And if you would, sir, begin to wrap up——

Mr. DAVIS. I will, and then I will wrap up on just a point, but I do not want you to answer any question other than the one I just asked you, because our time is so limited.

Is it possible and is it a reasonably foreseeable consequence that these kinds of amputations, these kinds of insinuations about the board, could end and of themselves damage the safety and soundness of Fannie Mae by weakening its position in the market? Is that possible?

Mr. FALCON. Our actions are all designed for the safety and soundness of this——

Mr. DAVIS. Is that possible?

Mr. FALCON. If we did our job properly perhaps, but we have not.

Congressman, let me just say, I understand your politics running all the issues.

Mr. DAVIS. No, I am just asking——

Mr. FALCON. We are just trying to do our job as a regulator. You can question my motives, my judgment, even my qualifications——

Mr. DAVIS. That is not the question I am asking.

With all due respect, Mr. Chairman, that is not the question I am asking.

Mr. FALCON.—but that will not change the contents of this report.

Mr. DAVIS. Is it possible that the market standing of Fannie Mae could be weakened by your testimony?

Chairman BAKER. Please be responsive to him.

Mr. FALCON. It is possible. And if does——

Mr. DAVIS. Thank you, you have answered my question.

Mr. FALCON.——course of actions we have taken, it is because of what the company has done, as we have outlined in this report.

Chairman BAKER. The gentleman's time has expired.

Ms. Hart, did you now have questions? Ms. Hart?

Ms. HART. Thank you, Mr. Chairman.

We have been watching this drama play out a little bit. As you know, the committee has considered a number of different proposals that actually would change your position, as far as being the regulator for GSEs.

And one of the things that I know during this debate that you have been seeking—and I think it is important—is to separate the roles of chairman of the board and CEO at both Fannie and Freddie. And I know that Freddie has agreed to do this, but from my understanding, up to this moment, Fannie Mae has not agreed to do this.

Can you tell us, first of all, as far as the agreement that you have with them goes, is there anything involving that in the agreement that you have with them and why you think that is important to have that separation happen?

Mr. FALCON. The agreement does not specifically cover the separation of the chair and CEO positions. It does require a review of the organizational structure to address issues of possible conflicts in different positions and functions.

We do have a corporate governance rule pending which would separate the position of chair and CEO. And we have proposed that and are moving toward a final rule on this because we found that, based on the situation at Freddie Mac, that this was just best corporate practice for these government-sponsored enterprises.

We found that the board could not properly fulfill its role as overseer over management as long as the CEO was also the chairman of the board of the company. And so, we entered an agreement with Freddie Mac, whereby they agreed to separate the positions.

And I must say that, to the board's credit, that didn't take much persuasion. I think they saw that this was appropriate in themselves. And so, they took this step. And with this corporate governance rule being in place, soon I hope, we will then require the same thing of Fannie Mae.

Our report on Freddie Mac certainly highlights the need for a government-sponsored enterprise which has imperfect market discipline to have a separation of these positions.

Ms. HART. If that is such an important point, why is your instruction in the agreement with Fannie so general?

Mr. FALCON. Well, because we intend to deal with this through our corporate governance regulation, while the overall issues about organizational structure get addressed by the board and us.

Ms. HART. Okay. I yield back. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Hart.

Mr. Watt, in the interim Mr. Crowley appeared, and he was ahead of you.

Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman.

Thank you, Mr. Falcon, for being here today, and thank you all for testifying.

I just want to go back a little bit of ways in the hearing. I was in the back room prior to the break for votes when Mr. Shays was asking you a number of questions. And in response to a question from Mr. Shays, you suggested, at least as I interpreted it, that investors could be harmed by the actions taken by Fannie Mae.

Could you tell me where that is in your report? Do you have that in your report?

Mr. FALCON. I think potential harm exists because of inaccurate financial statements being issued by the company.

Mr. CROWLEY. Is that an observation of yours, or is that in the report itself?

Mr. FALCON. It is in the report.

Mr. CROWLEY. Where in the report is that?

Mr. FALCON. The fact that we think that the company has issued inaccurate financial statements as a result of these accounting practices? I would have to go through and find the exact——

Mr. CROWLEY. If you don't mind, I would like to know, if you can. Maybe your staff can let my staff know where in the report that is.

Mr. FALCON. Absolutely.

Mr. CROWLEY. Just on Mr. Davis's line of questioning, which I thought was excellent, what effect do you think this report will have on the mortgage market?

Mr. FALCON. I think what we have seen to date is that the mortgage market has functioned well. There is continued liquidity being moved into the mortgage market. And despite Fannie Mae's problems, as found in this report, there haven't been any real disruptions in the mortgage market.

Mr. CROWLEY. Do you anticipate there will be any disruptions in the mortgage market because of this report?

Mr. FALCON. As long as the markets and the public see that we are working to take prompt corrective action——

Mr. CROWLEY. Yes or no?

Mr. FALCON. No.

Mr. CROWLEY. No, you do not.

Do you believe that this report shows any evidence that Fannie Mae may be departing from its mission of increased homeownership through making homeownership more affordable in this country?

Mr. FALCON. The report did not address that point.

Mr. CROWLEY. For example, I know Mr. Raines has pledged to create 6 million new homeowners, including 1.8 million minority homeowners, by 2014. Do you believe this goal may be threatened now because of this report?

Mr. FALCON. I don't think——

Mr. CROWLEY. I am going to ask Mr. Raines the same question, but——

Mr. FALCON. As long as the company is maintaining its adequate capital, as long as we have taken proper steps, along with the cooperation of the company, I think we will minimize any damage to their ability to meet their affordable housing goals.

Mr. CROWLEY. Let me finally—thank you. Let me finally ask you, while there are some things in this report that are damaging, in the text itself, it is the SEC, I believe, and not OFHEO that has the final say over whether or not Fannie Mae must restate past earnings. Is that correct?

Mr. FALCON. Yes. Ultimately the SEC has to decide whether their statements issued pursuant to laws were accurate.

Mr. CROWLEY. And some have argued to me that there is more than an even chance that the SEC may disagree with the most damaging allegations, such as accounting or derivatives and delayed recognition of expenses. Is that correct?

Mr. FALCON. I guess some have predicted that. I cannot speak to what others might predict. All I know is that we find these issues to be very clear violations of GAAP. And we feel confident that once the SEC takes an objective look at this, that they will come to the same conclusions that we have and that Deloitte & Touche has.

Mr. CROWLEY. Thank you.

Mr. FRANK. Would the gentleman yield to me?

Mr. CROWLEY. Yes, I will. I yield to the gentleman from Massachusetts.

Mr. FRANK. I thank the gentleman.

And I appreciate the answers, Mr. Falcon, you gave to Mr. Crowley. But it makes me even more disturbed that you, both in your written statement and again, sort of threw "safety and soundness" around almost like kind of boilerplate.

I think you just accurately answered the questions that, no, if everything works out as we expect it to, there are no threats, et cetera, this—you seem to be saying, "Well, these are in areas which could raise safety and soundness problems." I don't see anything in your report that raises safety and soundness problems. Your answers to Mr. Crowley certainly didn't indicate that there were.

How does this raise safety and soundness problems, other than the kind of, frankly, almost ritualistic saying, "Well, these are areas where safety and soundness could be implicated presumably if it went far enough"?

But I think it is irresponsible—let me be very clear—on the basis of this report and what you have concluded so far—I mean, we have earnings smoothed out. With regard to derivatives, you have told you me you cannot even say at this point whether they have under-reported or over-reported earnings.

How does this threaten the safety and soundness, what you have uncovered, of Fannie Mae?

Mr. FALCON. Just the very fact that we have serious doubts about the accuracy of the financial statements and their books and records, the very fact that we have identified very serious internal controls——

Mr. FRANK. Well, let me ask a question. Does any accuracy threaten the safety and soundness? That is what bothers me. There is a quality and a quantity issue here.

There are inaccuracies that can be disturbing, and if they led to inappropriate compensation, I would be very unhappy. But the notion that any inaccuracy implicates safety and soundness, I think, based on what you have said here, where you cannot even conclude—you have said you cannot even quantify any potential amount of loss. To throw "safety and soundness" around in that thing I think really is, for a regulator, irresponsible.

Mr. FALCON. Well, I think internal controls are a very serious safety and soundness concern. A breakdown or a lack of internal controls——

Mr. FRANK. Do you think the safety and soundness is at risk right now?

Chairman BAKER. Mr. Crowley, that will have to be your last question. If you can wrap up.

Mr. FRANK. He accepts that.

Mr. CROWLEY. That was my first question, as a matter of fact.

Mr. FRANK. Yes, I mean, you have just told Mr. Crowley it didn't implicate safety and soundness. Does it, your report, what you have reported?

Mr. FALCON. No, I think our report absolutely does implicate safety and soundness.

Mr. FRANK. Is the safety and soundness at risk now?

Mr. FALCON. Are they at risk of becoming insolvent right now? No. We have an agreement with the board in place that will address these problems, provide an adequate capital cushion. We think we——

Mr. FRANK. That is the answer. The rest is just rhetoric.

Chairman BAKER. The gentleman's time is expired once over.

Mr. Ose?

Mr. OSE. Thank you, Mr. Chairman. I yield 15 seconds to Mr. Shays. And I am counting.

Mr. SHAYS. Thank you.

I would just like to say to you, Mr. Falcon, what you have done is you have exposed illegal activity on the part of Fannie Mae, and you are being criticized for exposing it. If they have a safety and soundness problem, or if the markets are impacted, it will only be impacted based on what Fannie Mae did.

And I just want to congratulate you. You have more courage than I realized you had, because the messenger is being shot and not the person who did the wrongdoing. I have seen it here in this committee, and I am pretty outraged by what I am seeing.

Congratulations for what you have done.

Ms. WATERS. Would the gentleman yield?

Mr. OSE. Let me ask my—it is my time.

Ms. WATERS. Would the gentleman yield?

Chairman BAKER. It is Mr. Ose's time, and I think he wants to reclaim it.

Mr. OSE. I do want to reclaim it.

Ms. WATERS. Oh, he is reclaiming his time?

Mr. OSE. Mr. Falcon, I follow this stuff very carefully because, having weathered the storm on the games-playing that took place

in some of the energy companies, I am very, very sensitive to what might be occurring in the financial markets underpinning the housing market.

If I understand correctly, there are questions as to the validity of the numbers on an ongoing basis within the enterprise known as Fannie Mae.

Now, Fannie Mae's securities are held as tier-one capital by any number of additional institutions. My concern here is not so much the direct impact but perhaps the indirect impact that might manifest itself as a result of manipulation of earnings.

Could you speak to that issue? In other words, the secondary impact, if you will, outside of Fannie Mae, is that a possible consequence for banks holding Fannie Mae's securities as tier-one capital?

Mr. FALCON. The banks holdings in the debt of Fannie Mae—if there is some—might have undue concentration in Fannie Mae debt as a percentage of the total capital, if the problems were not addressed quickly with Fannie Mae such that we remedied the concerns that we have found, I think the bank regulators might have some concern about the devaluation in what is being held as capital of some financial institutions.

Mr. OSE. This is exactly the point that I think OFHEO properly has made, is that this issue is not constrained to the enterprise we know as Fannie Mae. This issue goes beyond the enterprise we know as Fannie Mae. That is why it is so important that the numbers that Fannie Mae reports accurately reflect the enterprise's activity. If they do not reflect the enterprise's activity, there are significant adverse effects outside the enterprise that we would end up being called upon to deal with.

That is why I am, frankly, pleased to see you bring this to our attention. I am troubled by what I hear. I am looking forward to the witnesses that follow you. And I thank you for your work.

Chairman BAKER. Would the gentleman yield?

Mr. OSE. And I yield to the Chairman.

Chairman BAKER. I would just like to point out to the gentleman, there is approximately 8,400 insured federal depository institutions. Of that number, in excess of 3,000 institutions hold 100 percent, not 50, not 70, 100 percent or more of their required tier-one capital in GSE securities.

It is of extraordinary consequence we fully understand that the financials are indeed accurate, because an impairment in the issuance of debt, it would not require the insolvency of an enterprise, merely an impairment in the ability to issue debt. If the regulator increases capital requirements, where are they going to go to raise the capital?

So I think the gentleman has raised an excellent point I think heretofore has not been recognized. I thank him for yielding.

Mr. OSE. I yield back the balance of my time.

Chairman BAKER. Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman. And again, thank the Chairman for allowing the nonmembers of the subcommittee to participate.

I think I may be the last questioner, so I want to try to follow up on a couple of things. Number one, Mr. Bachus, I believe it was,

asked about the leak the morning of the day you met with the Fannie Mae board.

My question to you is, are you undertaking any internal investigation to determine whether that leak was inside your shop at present?

Mr. FALCON. I will.

Mr. WATT. Are you presently, or you are planning to in light of the comments that were raised today?

Mr. FALCON. Yes.

Mr. WATT. Okay.

Mr. FALCON. And I guess I would also ask——

Mr. WATT. That is all I need to know.

Second, you made reference in response to questions that Ms. Waters asked to at least some conversations with members of Congress leading up to the time that you had the meeting with the board of Fannie Mae.

Would you be kind enough to provide to the chairman and the ranking member of this subcommittee a list of those contacts and the contents of those contacts? I don't expect you to have that with you today, but would you provide that to the chairman and ranking member?

Mr. FALCON. Sure, Congressman.

Mr. WATT. Okay. Now, let me kind of zero in on the bottom lines, as I have gathered them, and contrary to what Mr. Shays is saying, I am not second-guessing whatever conclusion the study. But I do have some problems with the timing of the release of this information.

Is it correct that you have not concluded whether the derivative conduct that you describe in your report either resulted in an overstatement or an understatement of Fannie Mae earnings?

Mr. FALCON. Right. The next step——

Mr. WATT. Okay. Just, is that correct?

Mr. FALCON. Yes.

Mr. WATT. Okay. And, now, since we have separated out that, we don't know what the financial consequence of that is.

Let me go to the primary thing that I want to get at, and this is at the bottom of page three of your statement. Right near the next-to-the-last sentence there you say, "Fannie Mae improperly delayed the recognition of income to create a 'cookie-jar' reserve that it could dip into whenever it best served the interest of senior management."

Now, the word "cookie-jar" makes it sound pretty small, but in actuality, the specific incident you are talking about related to $400 million in 1998. Is that correct?

Mr. FALCON. Yes.

Mr. WATT. And what you are saying is that in 1998, Fannie Mae made a decision to recognize only $200 million of that and then amortized the rest of it over 1999. Is that the bottom line on what you are saying?

Mr. FALCON. Yes.

Mr. WATT. Now, is it also then true that for 1997 and prior years, there would have had to be an understatement of revenue or income for Fannie Mae in order for Fannie Mae to have been able to create this "cookie jar"?

I mean, is that not what this means when you say they improperly delayed the recognition of income. Does that not mean that in some years to prior to 1998, they did not recognize income so they understated income. Is that not what that means?

Mr. FALCON. I do not believe so. I would like to have my chief accountant to explain to you, but I think it was just a function of——

Mr. WATT. Yes, well, tell your chief accountant to tell me what this means.

Mr. DICKERSON. The "cookie jar" is really a Securities and Exchange Commission term of art for——

Mr. WATT. I do not care about the term itself, but you cannot create a reserve in a cookie jar without having created some consequences to prior earnings. Is that correct, Ms. Deleo or whoever it is that is going to answer it?

Mr. DICKERSON. Congressman, our analysis and our special examination did not go back beyond——

Mr. WATT. I understand that. That is not the question I am asking. But you cannot really determine whether there was an overstatement or an understatement of earnings over time at Fannie Mae without going back beyond 1998, can you?

If they were creating a reserve that was supposed to level out earnings, they had to understate at some point and overstate at some point. Is that not correct?

Mr. DICKERSON. Well, Congressman, our examination found that there was $400 million——

Mr. WATT. I understand that. I have acknowledged that. I went through that in some detail and you went through it some detail.

The question I am asking is: In order to create the cookie jar reserve, would there not have had to be an understatement of income at some point just as there was an overstatement of income at some point?

Chairman BAKER. And someone please try to answer his question. The gentleman's time has expired.

Mr. WATT. I thought it was a pretty simple question myself.

Mr. DICKERSON. It was after this experience in 1998 that Fannie Mae implemented policies to create these cookie jar reserves beginning in 1999——

Mr. WATT. How can you say that and you did not even look at 1997? You do not know whether the cookie jar was already there or not, do you?

Mr. DICKERSON. I cannot really speak to the years before 1998, sir.

Mr. FALCON. Congressman, I think what you are getting at is: Was this there in 1997 and they just carried it forward or something to that effect.

This $400 million showed up in 1998 as a result of the change in interest rates and the amortization——

Mr. WATT. Well, what did they offset it against if there was not already a reserve? And how did they get the reserve if there was not already understated income at some point, or overstated income at some point?

I am just trying to figure out—I mean, this is a balancing act, right? And the objective is to smooth out earnings. Is that not right?

Mr. FALCON. This came up as a result of a change in interest rates and a change in the amortization of the expenses related to the mortgages.

So it is not something that is necessarily what you are suggesting. It is more of a factor of the models showed that they——

Mr. WATT. But is it necessarily what you are suggesting? That is the question.

Chairman BAKER. With that, the gentleman's time really has expired.

Mr. Director, would you care to respond to his last comment?

Mr. FALCON. No, Mr. Chairman.

Mr. FRANK. For something clear cut, that is pretty hard to explain.

Chairman BAKER. Mr. Director, on behalf of the committee I wish to express our appreciation for your courtesy with your appearance here today and for the work you do.

I know that, given the difficulty of this issue and strong opinions held by members from many perspectives, that the criticisms that you took today may be difficult for you and your staff to accept, given the length of time and the amount of effort you have put into production of this report.

I want to express our appreciation publicly for your effort, and be assured that our work going forward, like yours, will not stop with today's hearing.

Thank you very much, sir.

Mr. FALCON. Thank you.

Chairman BAKER. At this time I would like to ask our second panel participants to come forward, when it is possible.

At this time the committee welcomes our next two witnesses: Mr. Franklin D. Raines, chairman and chief executive officer of Annie Mae, and Mr. Timothy Howard, vice chairman and chief financial officer of Fannie Mae.

Gentlemen, by prior agreement with Mr. Kanjorski, it was determined that all witnesses appearing here today will testify under oath. Do either of you have any objection to testifying under oath?

Mr. RAINES. No, sir.

Mr. HOWARD. I do not.

Chairman BAKER. The chair also is required to advise you that the rules of the committee and of the House entitle you to be advised by counsel. Do you desire to be advised by counsel during your testimony today?

Mr. RAINES. No, sir.

Mr. HOWARD. Nor do I.

Chairman BAKER. In that event, let me ask you to rise and raise your right hand to affirm the oath.

(WITNESSES SWORN)

Consider yourself sworn in, gentlemen. Thank you.

Mr. Raines, we would certainly proceed with your opening statement first. Your official statement of course will be made part of the record.

Normally we request that witnesses try to make their statement in 5 minutes. However, given the nature of the report in question and the importance to your organization, certainly we would want you to proceed as you deem appropriate.

Mr. RAINES. Well, thank you, Mr. Chairman.

STATEMENT OF FRANKLIN D. RAINES, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FANNIE MAE

Mr. RAINES. My name is Frank Raines. I am the son of Ida and Delano Raines. I grew up in Seattle, went to public school, graduated from college and law school. I am a brother, a husband, a father and friend.

For all but two of the last 25 years, I have been in the financial services business, and those 2 years I served our nation as the director of the Office of Management and Budget.

I am now the chairman and CEO of Fannie Mae. And Fannie Mae is the nation's largest source of funds for homeownership and rental housing for low-, moderate-and middle-income Americans.

We like to say we are in the American dream business.

I introduce myself in this way not because I am a stranger to this committee, but because I do not recognize the person, colleagues or company that someone described this morning.

But I nevertheless hope that I can make a contribution to a constructive dialogue this afternoon.

I do thank you, Chairman Baker, and I thank Ranking Member Kanjorski, and Chairman Oxley and Ranking Member Frank for the opportunity to be here.

We appreciate this opportunity to answer your questions about issues raised in the September of 2004 report by OFHEO of a special examination of Fannie Mae.

I would like to begin by noting that this is the first opportunity that Fannie Mae and its board are taking to respond in an official forum to the allegations set forth in the OFHEO exam report.

We take this report seriously.

Out of respect for the regulatory process and for OFHEO, we have sought with great diligence to follow an orderly process throughout the special examination, which is ongoing.

We have chosen not to respond ad hoc to questions about the exam report's content or conclusions. Instead, we will provide our responses in the appropriate forums, including through the boards independent review to the Securities and Exchange Commission and to the Congress.

So I appreciate that the committee has provided this forum today.

Some people have mistakenly concluded that the company's agreement with OFHEO constitutes an admission by the company to the findings and conclusions of the report.

Let me clarify that this is not the case. The agreement itself states that the company was not admitting or denying any wrongdoing as a result of signing the agreement.

Fannie Mae respects the role of OFHEO as our safety and soundness regulator. The strong oversight OFHEO provides is critical, given Fannie Mae's significant role in the U.S. housing finance system and the financial system as a whole.

In our view, from a decade of experience working with OFHEO, I believe that our overall safety and soundness regime makes Fannie Mae a better company.

OFHEO has more examiners per regulated company than any of the bank regulators.

OFHEO's risk-based capital standard is a model for financial institutions globally and goes farther than new risk-based capital models being proposed for financial institutions with more complex operations than Fannie Mae.

The best financial institutions will tell you the same thing. They welcome the exam process because it fosters cooperation in making the institution the best that it can be.

A confidential and cooperative examination process builds confidence, both the regulators confidence in the company, but also the company's confidence in its own safety and soundness.

Now, while this special examination unfortunately departed from standard financial institution examination procedures, our obligation remains the same: to make adjustments needed to respond to OFHEO's concerns, just as any financial institution would do with respect to its regulator.

That is why the company, led by our board, promptly entered in to a regulatory agreement with Director Falcon to make changes to our accounting, capital and internal controls and organization.

And let me thank our board members, particularly our presiding director, Ann Korologos, for their dedication and efforts on behalf of Fannie Mae in the past 16 days. Their diligence made it possible to quickly set forth an orderly process to resolve the concerns raised by the OFHEO report.

In conjunction with the agreement, the board's independent review committee has hired the law firm of Paul, Weiss, Rifkind, Wharton & Garrison to conduct an independent investigation, led by former Senator Warren Rudman, of all the allegations in the special examination report.

The issue of whether our implementation of FAS 91 and FAS 133 was consistent with generally accepted accounting principles remains with the SEC.

This agreement and these measures are important steps toward addressing the matters raised in the OFHEO report and a way to move forward. Adopting these measures will make Fannie Mae stronger and even better able to pursue our mission and the business that fuels our mission.

That mission, after all, is our central function. Congress chartered Fannie Mae to expand access to homeownership for low-and moderate-income Americans, and we are committed to that mission.

Earlier this year we announced the commitment to create 6 million first-time homebuyers, including 1.8 million minority first-time homebuyers, over the next decade, and to do our part to raise the minority homeownership rate to 55 percent and beyond.

By quickly reaching agreement with OFHEO where we could, we are able to maintain our mission focus.

For those that may be concerned that some of these steps, particularly the 30 percent capital surcharge, will constrain our mission activities, let me say this: Fannie Mae will do everything in

our power to meet our commitments to expanding homeownership and affordable housing while also doing everything in our power to try to meet the requirements of the agreement.

Before I close, I would like to touch on the issues raised by the OFHEO report concerning our implementation of the accounting standards FAS 133 and FAS 91. These accounting standards are highly complex and require determinations over which experts often disagree.

First, the report alleges that in 1998 the company willfully violated GAAP in order to maximize executive bonuses. These are serious allegations. They concern events that occurred almost 6 years ago.

Importantly, I would note that the OFHEO report does not cite any documents or witnesses to support these allegations.

Upon reading of this allegation in the report, the company undertook to assemble the relevant facts. And we have learned of no facts and no other materials that support the allegation that the decision about the amount to book was related to bonuses.

Based on the facts as I understand them, the $240 million estimate was arrived at as part of an analysis conducted by our accounting and financial staff, independent of any considerations of compensation. Additionally, this analysis was documented at the time and was disclosed to and fully discussed with our independent auditor.

We intend to turn all of this factual information over to the independent committee of the board and its outside counsel for review.

Second, the report alleges that we misapplied GAAP with respect to two accounting standards, FAS 91 and FAS 133. We believe we applied those standards in accordance with GAAP, and our independent auditor, KPMG, reviewed our application of those standards and concurred.

Fannie Mae has previously issued and filed with the SEC financial statements that reflect the accounting and financial statement presentation that OFHEO has alleged to be inappropriate. Those financial statements were certified by me and by our chief financial office, Tim Howard, after a thorough process and audited by our independent auditor, KPMG.

Fannie Mae has not withdrawn those financial statements, and KPMG has not withdrawn its opinion that those financial statements were prepared consistent with GAAP in all material respects.

Rather, the issues that have been raised by OFHEO will be taken up directly with the staff of the SEC, which ultimately has the final authority over GAAP.

Our accounting staff has repeatedly determined that our policies and practices with regard to FAS 91 and 133 are reasonable and in accord with GAAP. And KPMG has issued unqualified opinions on our financial statements, and that remains their position today.

In fact, when I certify our financial statements, I certify that these documents fairly present, in all material respects, the financial condition, results of operations and cash flows of the company. That is a very serious statement, and I take it very seriously.

We engage in a rigorous due-diligence process before I ever put pen to paper and make that certification. I only certify after receiv-

ing assurance that I can say with confidence that our financial statements fairly present, in all material respects, the financial condition, results of operation and cash flows of the company.

Mr. Chairman, no one is more interested in a full and open examination of these issues than I am. I cherish this company. I believe in the mission that Congress challenged Fannie Mae to carry out. And I am inspired by the 5,000 women and men who come to work every day trying to help lenders help people get into homes.

Most of all, I believe that Fannie Mae's biggest challenge ahead is helping the financial system and mortgage industry to meet the growing and changing housing needs or our growing and changing nation.

This decade is expected to produce 30 million more Americans, who will create 13 million to 15 million new households. Minorities will represent 80 percent of that growth. And as a result, we estimate that 46 percent of future first-time homebuyers will be minorities and immigrants.

Serving their housing needs will require new ideas and innovations in mortgage financing. And we look forward to helping the industry with this challenge.

Given this public mission for which Congress created us and as an instrument of national housing policy, Fannie Mae expects and welcomes OFHEO's rigorous oversight to ensure that we are safe, sound, solid and stable for the long run. As I said the last time I appeared before this committee, strong oversight is in the best interest of Fannie Mae, our shareholders, financial markets and homeowners.

I want to make one thing very clear. I have always tried my best to ensure that our company does the right thing in the right way. And I believe to this day that we did.

If, however, after a thorough review of all the facts, it is determined that our company made significant mistakes, our board and our shareholders will hold me accountable. And I will hold myself accountable. That comes with being a CEO. I accepted that burden on the day I took the job, and I accept it today.

Thank you, Mr. Chairman and members of the committee. And I look forward to answering any questions that you may have.

[The prepared statement of Franklin D. Raines can be found on page 176 in the appendix.]

Chairman BAKER. Thank you, sir, for your statement.

Our next witness is Mr. Timothy Howard, vice chairman and chief financial officer of Fannie Mae.

Please proceed at your leisure, sir.

STATEMENT OF TIMOTHY HOWARD VICE CHAIRMAN AND CHIEF FINANCIAL OFFICER, FANNIE MAE

Mr. HOWARD. Good afternoon, Ranking Member Frank, Chairman——

Chairman BAKER. Make sure that mic is on, or pull it a little closer. We can't hear you the way we should.

Mr. HOWARD. Is it on now?

Chairman BAKER. Yes, sir. Thank you.

Mr. HOWARD. Good morning—or good afternoon, I should say. Thank you for inviting me to be here today.

I joined Fannie Mae in 1982 when the company was in the midst of a severe financial crisis brought on by flaws in its interest rate risk management. Under the leadership of David Maxwell, we were able to turn the company around and establish the solid financial footing that has enabled Fannie Mae to reliably provide hundreds of billions of dollars in affordable, fixed-rate mortgage financing to millions of low-, moderate-and middle-income Americans.

I consider it a privilege to have been able to devote the past 22 years of my career to this company and its mission. Throughout this time, I have tried my absolute best to do the right thing for the homebuyers Fannie Mae helps to serve, the employees I lead and the investors who have placed their trust in our company.

All of my judgments regarding accounting issues were made in openness and good faith, with the goal of providing investors with the most meaningful and understandable information possible.

When accounting issues arose, I worked with the head of my accounting policy group, who I know to be knowledgeable and highly respected in the industry. I also made certain that any accounting approaches we adopted were reviewed with our outside auditor.

I had a clear objective in guiding Fannie Mae's implementation of the two accounting standards that are at issue in the OFHEO report: FAS 133 and FAS 91. And that was to preserve the accuracy and utility to investors of our financial statements by reporting on what I honestly believed were the true economics of our business.

At all times, I believe that the accounting applications we adopted were within the boundaries defined by GAAP, as interpreted and understood by our accounting experts both inside and outside the company.

We filed financial statements with the SEC that were fully audited by KPMG, and as Frank said, Fannie Mae has not withdrawn these financial statements, and KPMG has not withdrawn its opinion that those financial statements were prepared consistent with GAAP in all material respects.

FAS 133 is widely considered to be the most complicated accounting standard ever issued. Its implementation had the potential to greatly reduce the clarity and utility of Fannie Mae's financial statements.

We recognized this challenge from the outset, but we did not attempt either to circumvent the standard or to violate GAAP to deal with it. Instead, we developed a separate earnings measure, core business earnings, to convey to investors our financial results in the absence of FAS 133.

FAS 91 requires that we estimate the average lives of the mortgages in our portfolio to determine the rates at which premiums or discounts on these mortgages should be amortized into our income statement.

By definition, this estimation process is imprecise. From the inception of FAS 91 in the late 1980s, we have used ranges to address this imprecision in estimating mortgage pre-payments. KPMG concurred with our use of a range.

Ultimately the SEC will resolve the issue as to whether our implementation of FAS 133 and FAS 91 is consistent with GAAP.

This is entirely appropriate. And I look forward to receiving the results of their review.

It is important to note, however, that the matters to be reviewed relate to accounting judgments and not issues of risk management. Financially, Fannie Mae is as strong as ever, and our ability to carry out our mission remains intact.

I look forward to responding to your questions on these matters.

[The prepared statement of Timothy Howard can be found on page 169 in the appendix.]

Chairman BAKER. Thank you, sir.

Mr. Raines, prior to the decision being executed to defer the $200 million in expenses in the end of 1998 into the quarters of 1999, were you consulted or did you have knowledge of that proposed transaction?

Mr. RAINES. Mr. Chairman, first, let me be clear. There was no decision made to defer any expense from 1998 to 1999.

Second—and Mr. Howard can go into greater detail into how the process actually occurs—but we did not make any deferral. I was part of a discussion, as I always am as the CEO, in our closing process in which the decisions made in our financial area with regard to the calculation of the catch-up provision was discussed. But the determination of that was made through our normal process of closing our books.

Chairman BAKER. So you did——

Mr. RAINES. But Mr. Howard will be able to give you more detail.

Chairman BAKER. Sure. So that you were involved in a discussion about the amount of catch-up required. And your view is that was that a customary process, not a decision made with regard to this specific expensing item.

Mr. RAINES. That was a discussion that we would have at the end of each period, discussing a variety of issues related to closing the books of any given year.

Chairman BAKER. Were there any discussions related to the consequences of that expense treatment in relation to the EPS?

Mr. RAINES. No.

Chairman BAKER. When did you first realize that the earnings-per-share figure would be $3.23?

Mr. RAINES. The first time that I would know what the earnings figure would be is when our controller would have closed the books and done all of the analyses necessary to determine what the final results are and then that would be reported to me. That would be after any decision that was made with regard to the catch-up provision.

Chairman BAKER. Was there any discussion in which you participated relative to the determination of the catch-up amount?

Mr. RAINES. No, I did not participate in determining the amount of the catch-up. That was done, as I mentioned, within our financial function, which is their job.

Chairman BAKER. I know you are knowledgeable of the Fannie Mae's Challenge Grant Initiative—I believe that was something that was organized in your administration in 1999—which initiated executive incentives for increased earnings.

Is it your view, or is it correct to assume that, including the $27 million of 1998 bonuses that were not part of the Challenge Grant

Initiative, because it was implemented I understand in 1999, that went forward from 1999 to 2003, that the total amount of bonuses granted by Fannie to those entitled slightly in the excess of $245 million?

Mr. RAINES. Mr. Chairman, I do not understand what you just said. Let me explain to you why.

Chairman BAKER. I will clarify the question for you.

In 1998, the bonuses reported were $27 million. And I can give you the figure for each year.

In 2003, the total amount of bonuses was $65 million, the yearly aggregate, the amount of bonuses each year, per year, 1998 through 2003, and that comes out to be $245 million.

If you are not familiar with that number——

Mr. RAINES. I did not understand what the question was.

Chairman BAKER. Did that help?

Mr. RAINES. You told me what the facts were about bonuses.

The Challenge Grant has nothing to do with bonuses. The Challenge Grant has absolutely nothing to do with bonuses.

Chairman BAKER. It does in a sense. Challenge Grants incentivizes executives to enhance the growth of the corporation's profitability, based on the corporation's profitability the EPS has calculated. The calculation of the EPS then determines whether the bonus trigger is hit.

In light——

Mr. RAINES. You just crossed the line again.

The Challenge Grant has to do with stock options. It has nothing to do with bonuses.

Stock options were granted to every Fannie Mae employee. Every employee of Fannie Mae was given a grant and would only vest if the company doubled its earnings over 5 years, and then it would vest over a delayed period if it did not.

So the Challenge Grants have nothing to do with bonuses.

Chairman BAKER. Well, let me clarify, then.

In 2002, Fannie Mae paid out a total of $51 million in bonuses of which $12.4 million was paid to the top executives.

I have a chart that is going up here now that shows total compensation.

Since we have talked about restricted stock awards, we have talked about stock options, and we have talked about bonuses, that chart characterizes what was awarded in 2002 based upon—what? If it was not earnings per share, per stock options, if it was not earnings per share or restrict stock awards, am I misunderstanding that the bonuses were not calculated based upon the earnings-per-share number?

Mr. RAINES. Again, Mr. Chairman, I think you are mixing two or three things together.

Chairman BAKER. I may be, but let's go through the detail——

Mr. RAINES. I would like to be helpful.

Chairman BAKER. I know.

Mr. RAINES. Let me try to answer the question——

Chairman BAKER. I will give you the right question that I would like to have answered, if it is possible: Did the $3.23 earnings-per-share determination in 1998 trigger the payment of bonuses to executives?

Mr. RAINES. Yes.

Chairman BAKER. Thank you.

Does the earnings per share have any effect on any of the other benefits awarded that are displayed on this chart, either the restricted stock grants or the options?

Mr. RAINES. Well, Mr. Chairman, this is your chart. This is the first time I have seen your chart. It has information on this chart that was provided to our regulator as confidential information, that it was information that is protected, in our belief, by the laws of the United States.

But be that as it may, now that you have displayed it before the committee, if I can answer your question.

Chairman BAKER. Sure, but to answer your legal point, I have the absolute right to display it, despite Mr. Ken Starr's threats to the contrary, in the context of a committee hearing discussing the policy of Fannie Mae's compensation.

Mr. RAINES. Mr. Chairman, I am going to answer your question.

Chairman BAKER. Well, please proceed.

Mr. RAINES. I am just pointing out the legal status of this information.

If we go across your chart, salary has nothing to do with earnings per share. Salary is established at the beginning of the year.

Chairman BAKER. I understand that.

Mr. RAINES. The second line you have is bonus. Those, in all these years—if I am correct, looking at this because it is very small type—is based on earnings per share, but not entirely.

Because individual employee bonuses also have a performance factor involved in them. And so the earnings that they would earn is not just based on EPS, but there are also on their performance.

Fringe benefits have no relationship at all.

Chairman BAKER. I was not raising that issue here.

Mr. FRANK. Mr. Chairman, are we all going to get this much time?

Chairman BAKER. I will be happy to cut him off if you would like for me to.

Mr. FRANK. I would like to go with the 5-minute rule.

Chairman BAKER. In order to move ahead, let me recognize Mr. Kanjorski.

Mr. BACHUS. Mr. Chairman, does he have a copy of this, other than reading off the chart?

Chairman BAKER. I have just recognized Mr. Kanjorski.

Mr. FRANK. I understand that. I wondered why Mr. Bachus was talking, then.

Mr. BACHUS. I understand, Mr. Chairman——

Mr. FRANK. Well, Mr. Kanjorski has the floor. Let us go to Mr. Kanjorski.

Chairman BAKER. Mr. Kanjorski has the time. He does have the information that came from Fannie Mae.

Mr. BACHUS. I did not know if he had this table before——

Mr. KANJORSKI. I do not have that chart. I think it is only on one side?

Chairman BAKER. Can we have it distributed?

It is being distributed now.

Mr. KANJORSKI. Well, shall I wait and hold my time so I would have the same information that the other side of the aisle has in their possession?

Chairman BAKER. Let me give you mine.

Mr. KANJORSKI. Well, thank you very much.

Mr. BACHUS. What I am saying is, do these two gentlemen have this——

Mr. KANJORSKI. Do all the members on our side of the aisle have it?

Mr. BACHUS. He is indicating that he does not have it.

Chairman BAKER. Time out. Hold up.

Ms. WATERS. I have not seen it.

Chairman BAKER. Hold up one moment. We will make sure that staff distributes it to every member——

Ms. WATERS. And to the panel.

Mr. KANJORSKI.——reproduction costs of the committee, are we over the allotted budget amount?

Mr. FRANK. Mr. Chairman?

Ms. WATERS. Parliamentarian query: Is this illegal or is it legal? I mean, there was a legal question raised here. Is it illegal for us to have this information? Can we display or not?

Chairman BAKER. No, Ms. Waters, it is not illegal.

Mr. KANJORSKI. Not for us.

Chairman BAKER. Not in the course of the committee consideration. I would not have released it had it not been. I have had it for over a year.

Mr. FRANK. Mr. Chairman?

Chairman BAKER. Mr. Frank?

Mr. FRANK. I have another appointment, but if the gentleman from Pennsylvania wanted to study this, I would be glad to go now and have him go after.

Chairman BAKER. Would Mr. Kanjorski like to yield his time to Mr. Frank?

Mr. KANJORSKI. Actually, Mr. Frank, I am not going to use this at all. As a senior member of the committee, I am smart enough to——

Mr. BACHUS. Mr. Chairman, I am just saying, I still do not think that the panelists have this table——

Chairman BAKER. Your point is well taken, Mr. Bachus. It will be delivered. Thank you.

Mr. BACHUS. But as we question them, I just——

Chairman BAKER. I said your point is well taken. It will be delivered. Thank you.

Mr. KANJORSKI. You mean there were not sufficient copies produced for the committee members.

Chairman BAKER. Let me put it this way: I wanted to make sure I released this information. I am accountable for its release, and I put it into the public forum pursuant to my rights as chairman, subject to a response from the regulator, and I wanted to make sure that I did not get criticized for leaks. And we had all these accusations that people got advanced information inappropriately before it was publicly released.

I have now publicly released it. I am accountable for that decision.

Ms. WATERS. Will the gentleman yield?

Chairman BAKER. And every member of the committee, everybody in the room has access to it.

Mr. KANJORSKI. Let me make a point, because I was very tough on the regulator, and I intend to be tough on Mr. Raines and Mr. Howard.

But, Mr. Chairman, may I point out that you obviously had to seek legal opinion as to whether or not you are violating the law by distributing this document.

And may I just say that opinion is opinion. You found a lawyer that gave you an opinion contrary to Mr. Kenneth Starr. And for the last time I recall, was not Mr. Kenneth Starr really most accomplished attorney in another proceeding——

Mr. FRANK. If the gentleman would yield——

Chairman BAKER. That is opinion.

Who is recognized? Mr. Kanjorski and Mr. Frank.

Mr. KANJORSKI. Mind if I take it now, Barney? Let me take the 5 minutes. Do I have 5 minutes?

Mr. FRANK. I have been trying to get to regular order. I am glad——

Chairman BAKER. Thank you, Mr. Frank. Please keep your members in order, we will be fine.

Mr. Kanjorski?

Mr. KANJORSKI. Maybe this goes to Mr. Howard and not to Mr. Raines, but either one of you, feel free.

When Mr. Falcon was before us, the regulator, he talked about discovering for the first time the smoothing of earnings in 1998. And the transaction that he describes as a $400 million item that should have been in but it was reduced to $200 million, but that it was cited somewhere in an audit difference.

I wanted to find out whether—and that was done by your outside auditors, as I understand at that time were KPMG. Is that correct?

Mr. HOWARD. Yes, it is.

Mr. KANJORSKI. Am I being incorrect when I said to Mr. Falcon that that would have been a finding or a difference in the audit that had to be resolved at the exit audit with either the board or management?

Mr. HOWARD. Mr. Kanjorski, it typically would have been identified by the auditor and discussed with the audit committee, and it was.

Mr. KANJORSKI. Now, that document, although it was not the final audit, something appeared in the final audit that would have reflected that working document draft, that there were audit differences expressed by your account.

Mr. HOWARD. It was mentioned in the accountant's report.

Mr. KANJORSKI. In the final audit.

Mr. HOWARD. Yes.

Mr. KANJORSKI. And the final audit, it seems to me, in 1998, were not only an internal document for the corporation, but that was provided and should have been provided to all the shareholders if they wanted it. Is that correct?

Mr. HOWARD. It typically is summarized in our annual report. The audit itself is not provided to shareholders.

Mr. KANJORSKI. Is it a secret document and not allowed to be read or understood by the regulator?

Mr. HOWARD. Not to my knowledge.

Mr. KANJORSKI. I am trying to gather: What in the hell does the regulator do when they regulate only two entities, and the first document they start with is not the outside audit, and particularly go to audit differences? Is that not what they talked to you about?

The new auditor found some audit differences there, and we want to know how you played it and to pass on whether you did it in conformity with the regulator's position that you acted properly.

Mr. HOWARD. Well, Mr. Kanjorski, I did spend a full day being interviewed by the special committee. They had an opportunity to ask me about this incident. I believe I could have put it in context that would have made it more understandable to them. They did not ask me.

Mr. KANJORSKI. No, I am just trying to understand: What does the regulator do if he does not start out with audit differences?

Mr. HOWARD. I cannot answer that.

Mr. KANJORSKI. It seems to me——

Mr. RAINES. The actual document you are referring to has been, in my understanding, provided to OFHEO. The working papers have already been provided to OFHEO.

Mr. KANJORSKI. But in 1998, did he have access to that document?

Mr. RAINES. Yes.

Mr. KANJORSKI. I am trying to figure out whether we really should get worried here and that we have not had close regulation, whether it is Fannie Mae or Freddie Mac, if they are not looking at some base document that would reflect audit differences from your outside auditor to see what adjustments were made and why, and then that being footnoted in the final audit report.

What happened here? Why 6 years went by and the regulator did not say, "1998, there was a little dispute between the outside auditor and the inside auditors in regard to how we treat this $400 million, or $200 million, adjustment."

Mr. HOWARD. Well, Mr. Kanjorski, I would say there was not even a little dispute. The outside auditor had recorded an audit difference similar to this each prior year on our treatment of this so-called catch up adjustment on FAS 91. This was not unusual, it was not new.

Mr. KANJORSKI. Well, what do we have to do, in terms of the committee, in authorizing a new regulator, or whatever powers we give a new regulator, so they do not come in here and say 6 months or 6 years later that there was this difference that supposedly then affects bonuses and compensation and all these things, but that they did not see it when it was about as clear as a battleship in the Potomac would be?

Mr. RAINES. Mr. Kanjorski, I am not sure there is anything that the Congress needs to do.

It is my belief, it is my understanding, that our examiners have had access to this information over all these years and simply have not made any comment about them.

So I do not think this is a matter of finding a secret document that have not seen before. I believe that the examiners had access to all——

Mr. KANJORSKI. I am not suggesting that there was secrecy. I am just getting worried about how superficial was the regulatory authority on your institution and Freddie Mac if they miss something that would have jumped out, audit differences.

Here is your outside auditor saying that, and obviously the regulator did not look at it.

Mr. RAINES. I guess what I am saying is, I do not know that they missed it back 6 years ago. The question is: How is it being characterized? The characterization may have changed.

Mr. KANJORSKI. Let us go to that point.

From that time in 1998 until now, it is your testimony, as I understand it, that KPMG had worked out and resolved in their mind, giving a full opinion letter on the audit, how it was treated in 1998 and how prior to that and how subsequent to that, that type of an adjustment was treated.

Mr. RAINES. Yes. In fact, I can read to you what they said to our audit committee in 1999 regarding 1998.

They said: The principal area of estimates and judgments in Fannie Mae's financial statements, including the amortization of premium and discount, KPMG did not identify any areas within the financial statement that they believe include unreasonable estimates.

That is what they said to our audit committee regarding 1998, having made that audit exception.

Mr. KANJORSKI. Well, their new auditor went in this last year, and did he find or did they find an audit difference there that they did not agree with, the opinion of your auditor?

Mr. HOWARD. Mr. Kanjorski, let me add one additional fact, and that is, after 1998 we worked to develop a specific method that limited the amount of the catch-up adjustment that we could allow not be recorded in a given year.

Once we put in place that procedure, which was the end of the year 2000, KPMG no longer recorded any size catch-up adjustment as an audit difference, provided it remained within the range that was set by our policy.

Chairman BAKER. Now, if the gentleman has one more and then——

Mr. KANJORSKI. Yes, I would like both of you to answer this question. It is a very simple question.

Is there anything of a systemic risk problem at Fannie Mae?

Mr. HOWARD. Absolutely not, in my judgment.

Mr. RAINES. No, sir. And the report doesn't indicate any, because all of our risk management practices are working very well and the company is very strong.

Mr. KANJORSKI. Thank you, Mr. Chair.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Shays, you are up.

Mr. SHAYS. I told your staff that I would like to listen to some of the questions before I begin mine.

Chairman BAKER. Mr. Royce?

Mr. ROYCE. Okay, thank you, Mr. Chairman.

In my opening statement, Mr. Howard, I said that, in my view, Fannie Mae has a moral obligation to conduct its operations to the highest standard of business practices. Do you agree with me on that?

Mr. HOWARD. Absolutely.

Mr. ROYCE. Well, the question I would like to ask is, has Fannie Mae acted in a way consistent with that belief? Does Fannie Mae have strong internal controls? Does Fannie Mae conservatively and consistently apply accounting rules?

Mr. HOWARD. I believe we do conservatively and consistently apply accounting rules. We exercise judgment in applying them to practical business situations, as is consistent with good accounting practice.

As far as the moral tone, I believe that we have an entirely honorable, decent staff, full of integrity, who have had a very difficult time in the past two weeks, seeing themselves characterized in a very unfavorable way.

Mr. ROYCE. I understand that. But there was an audit difference with your outside auditor——

Mr. HOWARD. An audit difference is simply a notation. It is not a direction for us to change the way we account for the transaction in question. That is a fact.

Mr. ROYCE. Well, the question I have there is, when OFHEO began the process of going back through the books—and in my view, OFHEO obviously has not been a very effective regulator. If they were exercising proper oversight, this issue would have surfaced in a timely matter and we would not be dealing with it now.

Mr. HOWARD. I am sorry, which issue?

Mr. ROYCE. The FAS 133 issue.

The other question I wanted to ask you was along the lines of what I asked Director Falcon. To follow up on that question, how does Fannie Mae's application of FAS 133 compare to other major financial institutions? Did you apply the standard the same way?

Mr. HOWARD. Well, Congressman Royce, I believe we made one major step that is different from most institutions. And that is that we realized that in order to faithfully implement FAS 133 in a fashion that did not make our income statements harder for investors to interpret and while still permitting us to use the hedging techniques that enable us to manage our interest rate and other risks, we needed to develop a supplemental earnings measure that adjusted for the effects of FAS 133.

FAS 133 adds an element of fair value accounting to what otherwise is a historical cost-income statement. And mixing those two concepts makes an income statement unintelligible to investors. We did not want that. We did not want to stop hedging. And we did not intend to undertake sham transactions to smooth out the effects of FAS 133.

So we developed a supplemental earnings measure called core business earnings that we publish to this day. I do not know of another institution that has followed that lead.

Mr. ROYCE. Okay. I thank you, Mr. Howard.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman.

First, I have to say to Mr. Raines and Mr. Howard, if it was—and I take the chairman at his word; I do not believe you would have done anything illegal—but if there had been any questions, there shouldn't have been. I think it is perfectly appropriate for this to be public.

I am a strong supporter of Fannie Mae and Freddie Mac, but you are not simply another private corporation. There is a lot of government involvement. I think this is entirely appropriate.

And, Mr. Chairman, I would have maybe given it to them in advance.

And I did have one question. There is either a mistake here, or there are either two people in managed capital or there is one person in managed capital who is getting twice.

[Laughter.]

But other than that, I think, yes, it is entirely appropriate.

And let me add to this. This is not directly relevant, but—and here I would say that this is a problem with regard to American corporations in general.

You gentlemen work very hard and you do good work, but I do not understand why in the world you need bonuses. At the level of compensation you get, we ought to be able to count on you to do your very best without any kind of incentive. And I would hope you would set a good example.

If your salary is too low, raise your salary. But I think incentive bonuses, particularly if they are connected to stock options—and there is no evidence of it happening here, with regard to stock options—but with stock options, top executives are given a perverse incentive.

If either one of you runs into a building that is on fire and rescues a baby, get a bonus. But doing your job, not at all level—my level, your level—I think that is a mistake. And to the extent that they are performance-related, we leave ourselves open.

If you want to comment on that at the end, you can do that, but I would just ask some questions now, because, to the extent that there was smoothing out that might have been affected by this—well, let me ask, because that is the major question.

Was the fact that bonuses were somehow dependent on certain earnings a factor in the treatment of earnings? And if you did not mean it consciously, might it have affected you, do you think? Mr. Howard?

Mr. HOWARD. If you are referring to the incident reported in the OFHEO report for 1998, as Mr. Raines mentioned, we have been looking into that. And so far we have determined that the amount that was determined to be accurately recorded in 1998 was determined as a result of a process that was run in——

Mr. FRANK. I am going to your motives. You both deny that trying to hit a certain amount so you could get your bonuses was a factor to any extent in your decisions? I think it is important to just ask you that question.

Mr. HOWARD. Yes, in coming up with that number, yes, we do not——

Mr. RAINES. We both deny that.

Mr. FRANK. You both deny that?

Mr. HOWARD. Yes.

Mr. FRANK. Okay, I think it is important to get that.

Next question is, in your reading of these—and I will repeat what I said previously, that accounting for derivatives does seem to me—and I know Mr. Falcon said, "Well, it is very clear-cut," but as Mr. Watt asked Mr. Falcon and his two chief aides a fairly straightforward set of questions, it got less and less clear to me and it did not appear to them to be as clear-cut.

And I will say, my sense is accounting for derivatives ranges somewhere between alchemy and astrology. You are accused of being on the alchemy end.

And that as they have gone over it with you, have they pointed out—and Mr. Falcon said no, but is there any decision, first of all, whether you are considered by them to be guilty on the whole now of under-reporting, of over-reporting? Do you know whether they think you over-reported or under-reported?

Mr. HOWARD. I do not.

Mr. RAINES. No, we can't tell from reading the report.

Mr. FRANK. So they have not even concluded whether you over-reported or under-reported.

I did notice the Merrill Lynch report said, given this category, that it was a situation of the sort where when interest rates rose, there would probably be gains, and when interest rates dropped, there would probably be losses.

Mr. Howard, is that accurate?

Mr. HOWARD. Well, there is a certain type of derivative that we use, which, when interest rates fall, it declines in value and, when interest rates rise, it rises in value.

Mr. FRANK. What percentage of the contested derivatives are in that category, do you know?

Mr. HOWARD. To be honest, Mr. Frank, I am not sure which derivative transactions——

Mr. FRANK. Okay. To the extent that they are there, obviously we would expect there to be an increased rather than a decrease in the near term.

Mr. HOWARD. If interest rates rise.

Mr. FRANK. So, now, when you agreed with them to increase your capital by 30 percent—I am going to ask you what your sense was. Mr. Falcon has acknowledged that since they had not come to any conclusion as to whether you had under-reported or over-reported, the 30 percent was certainly not based on any estimate of to what extent your capital might have been impaired.

In other words, there were no numbers there. It was simply that in the statute there is a 30 percent figure that is there, really, for somewhat other purposes, not for dealing with accounting for derivatives. And he borrowed it because it had some reality.

Did you get any indication why 30 percent was chosen other than that?

Mr. RAINES. To be clear, the agreement was negotiated by our board.

Mr. FRANK. Oh, okay. So we have to ask Ms. Korologos.

Mr. RAINES. And my understanding is this is the number that the director wanted.

Mr. FRANK. And as he said, it is not based on any—we have to be very clear. The 30 percent was not based on any analysis of inadequacy of capital. It was not based on any conclusion that the capital had been impaired.

Again, to the extent that there was inappropriate smoothing out, that is wrong, and it is being looked into. It should be corrected. But worst case, it does not seem to me that anything has been suggested that jeopardizes your going forward as a corporation.

Mr. Falcon disappointed me, as I told him, when he acknowledged to Mr. Watt and others, to me, that there was no threat to solvency, no remote threat to solvency that he talked about, but said somehow safety and soundness was implicated.

In their conversations with you, has anything been adduced to suggest that you are going to have to curtail, to some extent, your activities or that the investors are somehow at risk? Mr. Howard or Mr. Raines?

Mr. HOWARD. Not in conversation with me directly.

Mr. RAINES. No, sir. There have been no conversations that we were at risk, other than what is included in their report.

There is the issue of how we get to the 30 percent additional capital. And there obviously are some people who would prefer that we reduce what we do in the market——

Mr. FRANK. Right. And that is my next question, which is, you know, HUD—and I will finish in just——

Chairman BAKER. I just want to keep regular order, as you suggested.

Mr. FRANK. I understand. I am just trying to keep up with you, Mr. Baker. You are my role model.

Chairman BAKER. Start earlier.

Mr. FRANK. Thank you.

We had HUD last year not exercise its right to increase your goals. As you know, HUD had the right, a year before, to—last year they could have promulgated an increase in your affordable housing goals that would have taken effect this year. They didn't do it. It was an oversight, according to the secretary; they forgot to do it.

Now they are talking about increasing. And I certainly want to see an increase in the amount of affordable housing. But obviously if your overall activity shrinks, we are in trouble because, if I am correct, your affordable housing goals are not absolute but they are percentages of your overall activity.

So the question is, what will the effect of the 30 percent additional capital be on your reaching an absolute amount, in terms of affordable housing?

Mr. RAINES. The answer is, we don't know yet. We have a 45-day period to come up with a capital plan, under the agreement, which we will do.

We don't have a lot of choices. As you know very well, you either can reduce the size of your activities or you can increase the amount of capital that you have. If we have to reduce the size of our activities, then the percentage made up of the affordable housing goals will go down because we will be doing less business.

Mr. FRANK. So that arbitrary 30 percent might result in a diminution in your affordable housing activity?

Mr. RAINES. Well, if the capital plan requires us to reduce our activities, yes, it would reduce the impact of the goals as a result of our having made those choices.

Mr. FRANK. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, sir.

Mr. Shays, did you want to go now?

Mr. SHAYS. No.

Chairman BAKER. Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman.

One of the issues I wanted to ask about is something I was asking OFHEO today. It is on the generally accepted accounting practices.

At the point in time, when they came in and said that there was a willful violation of the accepted accounting practices, I asked if in fact OFHEO had talked to the Fannie auditors and whether Deloitte & Touche, in fact, had talked to your auditors at that time, to see why those auditors recommended to you to use certain accounting practices.

And I just wondered if you had any comment on that, about should Deloitte & Touche sit down prior to this report, is what I guess I am getting at. And that was the plan made with OFHEO.

Mr. RAINES. Well, I believe that they should have sat down with the auditors and asked them what was their view on these issues, because our auditors have obviously been looking at these issues for many years and they have an opinion on public record as to how they have come out on that question.

So I believe that they should have sat down with them before coming to the conclusions that they have come to, because obviously KPMG has come to a different conclusion than OFHEO has.

I don't know what the positions of Deloitte & Touche are. The report doesn't tell us, and I think the director testified that the findings in the report were OFHEO's. So I can't comment on what the positions of Deloitte & Touche are on these issues. We know what KPMG's positions are on the issues.

Mr. NEY. I will speak for what OFHEO said today. If I recall correctly, OFHEO said that Deloitte & Touche concurred with OFHEO.

And my follow-up question was, did Deloitte & Touche at any point in time communicate with your auditors to see why? And I wondered if, at any point in time, if Deloitte & Touche concurred, had they at any point in time had any contact or working papers of your auditors?

Mr. RAINES. Not to my knowledge.

Mr. HOWARD. Nor to mine.

Mr. RAINES. Not to my knowledge that there has been any contact either by OFHEO or by Deloitte & Touche with KPMG to explore these issues.

Mr. NEY. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Who is next?

Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Raines and Mr. Howard, your accuser, OFHEO, has spent the better part of four hours this morning making some extraor-

dinary accusations. And I want to make sure that you have ample opportunity to refute those accusations, a fair amount of which is this: that essentially you all cooked your books so that you could meet certain earnings targets so that you could get bonuses.

And the chairman has passed down this sheet, and one look at this sheet puts, in my estimation, some very strong, strong incentives.

I think we owe you the opportunity to make sure that you have the opportunity to refute that charge first.

And I know, Mr. Chairman, I have 5 minutes, if you will allow me to get that question out, then I have two more questions on the line of politics and process, but I want you to answer that charge because I think that is at the center of this hearing this morning.

Mr. RAINES. Well, thank you for that opportunity.

This is a very serious allegation, and I deny that occurred.

We have looked for the facts. There were no facts in the OFHEO report. None. Other than their calculation that said, "Oh, there seems to be if we subtract one number from another you get this result."

But we looked into the facts of what happened back 6 years ago, and we found no facts that would support the allegation that was included in the report.

Mr. SCOTT. Why, then, would OFHEO, in your opinion, make that charge?

Mr. RAINES. Well, Congressman, I do not know. This entire examination has been unusual. It has been the most unusual regulatory endeavor I have seen in the 30-some-odd years I have been in this city.

And I have never seen the case where a regulatory agency brought serious allegations against a company without asking the company for a response in advance.

So I do not know. This has been something that is inexplicable to me as to why they would follow this path. And I do not believe there has been an adequate explanation of why they followed this to this moment.

Mr. SCOTT. I asked your accuser this morning: When did they make this report public and when they did inform you of the report?

I would like to have your interpretation of those chain of events.

Were you made aware and briefed on this report by your oversight accuser prior to them making it public?

Mr. RAINES. Let me walk you through the entire sequence very quickly.

We began reading newspaper accounts that OFHEO was about to finish a report. I personally called the director to talk to him about him, to set up a meeting to talk about it.

I was unable to have a conversation with him about it or to have a meeting with him about it.

On Friday, at about 4 o'clock Eastern Time, members of our board were called and told that the director wanted them to assemble on Monday, to meet with OFHEO officials to hear about the report.

On Monday, four OFHEO officials came to Fannie Mae to brief our outside directors, and at that same time they handed to management a copy of the report.

They then proceeded to brief the board on Monday.

But as you know, much of the information about the report was not only in the political press, but also was in the financial press prior to that Monday.

Mr. SCOTT. Let me ask you: When did the board make the decision to link, and they did actually make the decision to link executive pay bonuses to earnings per share?

Mr. RAINES. Fannie Mae has linked bonuses to earnings per share for as long as I have been around the company. That goes back to 1991. Tim Howard has been there longer than I have.

Mr. HOWARD. I cannot recall a year in which they were not linked.

Mr. RAINES. And indeed, virtually every company of which I am aware links some part of their compensation to earnings per share. So this is not an unusual thing; this is one of the most common aspects of corporate——

Mr. SCOTT. Well, the point I wanted to get on the record was: The linkage was made prior to you being chief executive officer.

Mr. RAINES. Absolutely, prior to my even being at the company.

Mr. SCOTT. So this was not done on your watch. It was done and it has been normal procedure to link——

Mr. RAINES. Yes, sir.

Mr. SCOTT. Now, Mr. Howard, one point: You are the vice chairman of the board——

Mr. HOWARD. Yes.

Mr. SCOTT.—you are the chief financial officer——

Mr. HOWARD. Correct.

Mr. SCOTT.——you are the supervisory person over internal audit.

Mr. HOWARD. That is not correct. The internal auditor reports directly to the chairman of our audit committee. He has what is called a dotted-line relationship to me, which means I am his internal point of contact in the company.

Mr. SCOTT. Do you not approve his salary?

Mr. HOWARD. I do not. I make a recommendation on his salary to our senior management group, and his salary is determined collectively in consultation with the chairman of the audit committee.

Mr. SCOTT. But you do set the targets, financial targets, for the year, you said.

Mr. HOWARD. The financial targets are set collectively by the senior management team.

Mr. SCOTT. But you do have the authority to meet those targets.

Mr. HOWARD. No, I do not.

Mr. SCOTT. Oh, you do not. That is good to know, because there have been some reports that you did.

Mr. HOWARD. There have been lots of things that have been said incorrectly.

Mr. SCOTT. That is why I want to make sure that you have ample opportunity to refute. This is a very serious hearing.

I think the future, the jeopardy of Fannie Mae is at stake. And I want to make sure we give you ample opportunity to answer every one of these charges.

Mr. HOWARD. If I may take advantage of that opportunity and just be very clear in what we are saying, there is no linkage, to my knowledge, of compensation to the determination of what the catch-up charge would be in 1998.

We found no evidence of a linkage of that to compensation decisions for 1998.

Mr. SCOTT. Thank you.

I yield back the balance of my time, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. Raines, welcome back.

I am sorry if I am plodding over old ground, but I just got back in the committee room.

Mr. Raines, I wanted to ask you in regard to the Freddie Mac issue: You stated that Freddie Mac to make its GAAP earnings less while Fannie Mae—this is your quote—reported and explained the volatility. The OFHEO report finds that Fannie Mae misapplied GAAP, due to among other things, managements desire to portray Fannie Mae as a consistent generator of stable and growing earnings.

I guess the question occurs: What is the difference, in your case, between Freddie and Fannie in that regard?

Mr. RAINES. Mr. Chairman, they tried to get me with no chart. I had to have one. And this simply illustrates the major point.

That is our reported earnings. That is what we are accused of having made stable.

And if this was what we are trying to make stable, we did a very bad job of trying to stabilize our reported earnings.

And that is really the big difference between what Freddie Mac admitted they did and what we are accused of.

Freddie Mac was accused of trying to straighten out that orange line, and that they entered into transactions to straighten out the orange line. That is the GAAP earnings line.

And then they said, yes, that is what they did.

And what we did instead was, we have two ways of reporting the earnings. We simply report the volatility in GAAP, and we say,"Here's another way to calculate it in core. You the investor now have both ways to calculate it."

So I am not exactly sure what is meant by the accusation that we were smoothing earnings, because FAS 133 is not even included in core—the impact on net income is not even included in core business earnings.

So that is why we have a little difficulty understanding what the accusation is.

But the difference between us and Freddie Mac is that OFHEO is saying we have misapplied accounting standards. They link us smoothing; we do not understand what that means.

Freddie Mac said they were trying to smooth.

Mr. HOWARD. Mr. Chairman, as you can see from the chart, even the core business earnings line is not particularly smooth in recent

years. So whether it is GAAP, which we made no attempt to change with transactions that were not economic, or core business earnings, the allegations of transactions to smooth earnings, or accounting manipulations to smooth earnings does not appear to be substantiated by the actual earnings results.

Mr. OXLEY. Let me also ask both of you: On your Web site, you claim that the hedge accounting treatment for each individual transaction is determined and documented in writing before you enter into that transaction.

And furthermore, you say it cannot subsequently be changed.

The OHFEO report disagrees with that assessment, citing instances where there was no contemporaneous hedge documentation as well as instances where staff created hedge designations retroactively.

Do you disagree with those allegations?

And does FAS 133 not require full documentation for transactions——

Mr. HOWARD. First of all, Chairman, there are two separate issues, which I will address separately.

The first set of documentation that you were referring to was documentation of hedge transaction types.

Before we can enter into any given hedge transaction type, we have a hedge policy developed that is worked out by our accounting policy group, that is within our controller's department, but independent of other groups.

So all they do is accounting policy. And that accounting policy is reviewed with the outside auditors.

So before we do a single individual transaction, we have an agreed-upon derivatives or hedging policy.

Now, where the difference of viewpoint in the OFHEO report arises is over agreement on whether individual transactions were documented sufficiently. We believe they were and therefore qualify for hedge accounting.

OFHEO, in certain instances, contends they were not and therefore these transactions may not qualify for hedge accounting.

Mr. OXLEY. Does the report cite specifics? And if so, are there disagreements on the specifics? Or is this a generalization?

Mr. HOWARD. The report cites specifics. I am not intimately familiar with those specifics since I do not deal with them at that level.

Mr. OXLEY. Mr. Raines, do you have any comments?

Mr. RAINES. Again, I do not know about the individual specifics in the report, but their general position is that our way of documenting, with the combination of contemporaneous paper documentation plus automated systems, they believe does not meet their test.

We believe it does meet the test of GAAP.

Mr. OXLEY. And finally, in my opening statement I talked quite a bit about the application of the Sarbanes-Oxley Act in this particular case.

You of course are a publicly traded company and are subject to the requirements of the act as well as regulations therein.

Is there anything in your estimation to give any indication that any of the provisions of the act or the subsequent regulations had been violated or ignored?

Mr. RAINES. No, sir, I do not know of any. In fact, I think the act has been very helpful to us, because one of the reasons that we have documentation on a lot of these things is because we are going through the process as required by the Sarbanes-Oxley Act. That is why we have, as I described in my written testimony, this entire process around certification so that we know exactly at the highest levels of the company what decisions were being made and by whom.

And also I can tell you, as a result of the Sarbanes-Oxley, I have made a campaign in our company to go around and tell people, "If you think there is something wrong, raise your hand. Raise your hand, and it will be looked at that."

That has been our policy and that continues to be our policy, and I have to say, the direct growth from the reforms that were brought in by Sarbanes-Oxley.

Mr. OXLEY. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the chairman.

Mr. Clay?

Mr. CLAY. Thank you, Mr. Chairman.

And thank you, Mr. Raines and Mr. Howard for being here.

Mr. Raines, in May of this year, Dow Jones International News reported that Senator Kit Bond, Republican from Missouri, was so critical of OFHEO's leaks to The Wall Street Journal that he asked HUD's inspector general to examine OFHEO's practice of handling confidential information with the media.

This morning I asked Mr. Falcon a question such as: Why did the examiners not discuss preliminary concerns of possible findings with Fannie Mae? Why was Fannie Mae not provided a draft report? And why did Fannie Mae not have the opportunity to respond to findings?

I question why the process for handling these findings was altered and done differently for Fannie Mae. I find this to be inconsistent and a rush to judgment.

In informal conversations with the executives from Wall Street and individual large brokerage houses, I get the feeling that the markets are not worried about the safety and soundness of Fannie Mae, as OFHEO says that it is. But of course, the markets are not political. I do not see due process being carried out with respect to Fannie Mae.

Do you have an opinion on this, Mr. Raines?

Mr. RAINES. Well, Mr. Clay, as I testified, you know, we are a regulated company. We recognize we are a regulated company, do everything we can to work cooperatively with our regulator. And we will continue to do that regardless of what has happened with regard to this special examination. They have a job to do and we have a job to do.

By the same token, I don't believe that because we are a cooperation that we are not due due process. And I think we have a long tradition in this country of providing due process even to people who have done the most heinous things. They have been accorded

due process. And that is all we have really asked for thus far is give us the opportunity to state our case and let us take these issues to someone who can resolve them.

Now there have been many issues like this resolved by other regulators, banking regulators, without newspaper headlines. The issues that relate to FAS 91 and 133 we can discuss forever, but the SEC is going to decide.

And in my view, there is no reason the issues couldn't have just been taken directly to the SEC before any examination was completed and just ask them what is the answer. Then we wouldn't be having a debate here about, you know, whether or not the regulations embodied in this book are simple.

A regulation that has 172 interpretations that have come out since it was—we wouldn't be having that debate if we had done the simple step of going to the SEC, in which we would have joined in and said what is the answer? And then we would all know what to do going forward.

Mr. CLAY. I know that Fannie Mae has agreed to the increase in capital and how much in dollars is that increase?

Mr. RAINES. We don't have an exact estimate, but if you look back at the most recent periods it would require something in excess of $3 billion.

Mr. CLAY. Okay. I commend the company for this and for agreeing to other changes that will make for better transparency. Nevertheless, how would this almost $3 billion have been used were it not required for capital? I mean will the housing mission be affected adversely by this increase? And will it help the housing mission?

Mr. RAINES. Congressman, the honest answer is I don't know yet. We have 45 days to come up with a capital plan, but we don't have a lot of choices. And it could require us to reduce our activities because we have only 270 days to come up with the $3 billion. And that is just one of the issues we are going to have to struggle through.

So, it is possible it could require us to reduce our market activities to achieve the goal.

Mr. CLAY. I thank you for your response.

Mr. Chairman, that is all for me. I yield back the balance.

Chairman BAKER. I thank the gentleman.

Ms. Kelly?

Ms. KELLY. Thank you, Mr. Chairman.

I have very little time, Mr. Raines. And I would appreciate it if you could answer my questions within a yes, no format. I really appreciate the presence of both of you before the committee today.

Mr. Raines, which member of the executive management team is responsible for risk management, accounting, on-balance sheet mortgage portfolio, business planning, tax, investor relations and internal audit? Do you have one member who——

Mr. RAINES. There is no one responsible for all those things unless you are thinking of me. But there is no one person responsible for all those things.

Ms. KELLY. Well in the OFHEO interview with Tim Howard he said he had those portfolios.

Are you aware that, as the director of financial accounting, Jeff Guliana has responsibility for modeling critical accounting estimates, as well as reporting and accounting for model results? Just give me a yes or a no please.

Mr. RAINES. I think the answer is yes.

Ms. KELLY. Thank you.

Are you also aware that a senior vice president for financial reporting and planning, Mrs. Janet Pennewell, is responsible for reporting net income, as well as forecasting what net income will be? I just need a yes or a no, sir, please.

Mr. RAINES. Ms. Kelly, sometimes when you phrase it in a way that is not exactly right giving you a yes or a no may be misleading to you. So——

Ms. KELLY. Well, that is in the OFHEO report in that way. So, I just——

Mr. RAINES. That may well be——

Ms. KELLY. Is that true? I mean does this woman have—does she report net income, as well as forecast what the net income will be? That is what I read in this report.

Mr. RAINES. If you put it that way, no.

Ms. KELLY. Okay.

Mr. RAINES. But, I was trying to be helpful, but if you put it that way, the answer is no.

Ms. KELLY. I am sorry. I have a bill on the floor and I have to get back over and I have to get through this because I really need answers to my questions.

Are you aware that a senior vice President for the operations risk, Sam Rajappa, was, and is still, apparently responsible for auditing his prior work as controller? Just a yes or a no, please, sir.

Mr. RAINES. No, he is not responsible for auditing his prior work as controller.

Ms. KELLY. Okay. That is, again, that was in his interview, that is apparently what he said he was doing in the OFHEO report. Mr. Rajappa says he was employed as Fannie Mae controller from 1994 to the end of 1998, which was the time period where earnings manipulations to trigger executive bonuses is alleged.

Were you aware that that arrangement was a clear contradiction of the IAA standards relative to the auditor independence? Did he assume that he was doing this and he wasn't?

Mr. HOWARD. I can actually help there. Mr. Rajappa was moved in as head of operations risk but the auditor at the time was a man named Jack Wassen. Mr. Wassen was the company's auditor. Mr. Wassen reported to Mr. Rajappa. So there was no violation of that standard at the time.

Ms. KELLY. Thank you.

Mr. HOWARD. You are welcome.

Ms. KELLY. According to, again, the OFHEO report, Mr. Rajappa reports to you, Mr. Howard, is that true?

Mr. HOWARD. I have been chief financial officer for 14 years. For the first——

Ms. KELLY. Sir, I just need a yes or no answer.

Mr. HOWARD. No.

Ms. KELLY. He is not now or has he ever?

Mr. HOWARD. No, he reports to the chairman of the audit committee. He does not report to me.

Ms. KELLY. Okay. What about the members of the executive committee? Do you meet, and according to what the OFHEO interview shows, the executive team met to cooperatively set salary and bonus for Mr. Rajappa, as well as Mr. Rajappa being available to audit the executive team. That is what is in the report. I just need to know from either one of you a yes or a no.

Mr. RAINES. This is very hard to give yes or no answers to——

Ms. KELLY. I understand that, sir——

Mr. RAINES. But——

Ms. KELLY.——but I have a very limited time.

Mr. RAINES. I understand, but the implication of my giving you an answer that is incorrect is so great that I refuse to take the risk without telling you what the real answer is.

The answer is that the compensation for everybody in the company, including mine, is in part determined by our executive team. We have in process where lots of people are involved in setting the compensation. So, the answer is yes, but that is not an unusual thing.

Ms. KELLY. Okay.

Mr. Raines, as the CEO of a major company this committee and I believe the American people, investors, taxpayers and homebuyers, expect you both to know about these operations and to be so intricately involved in the decisions and processes of the company that questions like mine could be able to be answered with a quick yes or no. There needs to be bright lines for who is reporting to whom and who is doing what.

When I read this OFHEO report I did not see bright lines. If there are bright lines, sir, I would hope that perhaps you could get us a construct of exactly what they are. If they do not agree with OFHEO so be it. But it would be important for us to know how you have Fannie Mae structured because I believe quality and transparency is what the American people deserve.

Thank you. I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

Mr. Baca?

Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman.

Well, I don't have a bill on the floor and I have plenty of time. So, if either of you gentlemen would like to expand on the previous yes/no answers in any respect, feel free to do so right now. As someone who has grown up in public housing, I have a real investment in Fannie Mae's mission. And I see the good work that you do.

Let me just—you know, the previous speaker mentioned that she saw no bright lines in this OFHEO report. This is 200 pages. I just want to ask you again, just to be sure in my own mind, did OFHEO sit down with you and interview you, Mr. Raines or Mr. Howard in preparation of this, this examination of your corporation, of Fannie Mae?

Mr. RAINES. They did not interview me.

Mr. HOWARD. They did interview me on two occasions; one to discuss impairments on certain types of securities, and one was a more general interview.

Mr. LYNCH. Okay. And what about sitting down with your auditors, did they sit down with your auditors about this report?

Mr. HOWARD. Not to my knowledge.

Mr. RAINES. I do not believe that they have interviewed our auditors. But to be clear on your question, since they have done the—finished the report, they have not talked to us either about the content of the report.

Mr. LYNCH. Well it is not surprising then that there would be no bright lines in this and that some of these accounting rules are fairly complex and one would certainly understand how there might be differences of interpretations as you have pointed out.

In your own minds as the CFO and CEO, is this a usual relationship with a regulator that they would go around you and not sit down extensively with you to try to bring you into compliance with a GAAP that they thought you were in noncompliance with?

Mr. HOWARD. For me it is an unusual relationship.

Mr. RAINES. Congressman, I would agree that it is an unusual relationship. I did note in Director Falcon's testimony that he gave a reason why he felt the necessity to go around senior management he said was the lack of cooperation by senior management. And if I could address that issue, I would——

Mr. LYNCH. I would like you to.

Mr. RAINES.——be delighted.

We had our first meeting with OFHEO with regard to this special examination on January 7. Since that date we produced 427,466 pages of documents, in 67 different document productions and 14 different requests, answering 425 questions. We also provided 966,367 pages of e-mail and e-mail attachments.

We have even provided on three different occasions, our own consultant to go to OFHEO to help OFHEO with their technology in managing their searching of our e-mails. We had 100 people working for 4 days to respond to just one of their e-mail requests.

We have made Fannie Mae people available 47 times to be interviewed as part of this process. Now we provided to them the working papers of KPMG and quite a bit of other information.

I met with Director Falcon and told him, or informed him that if there were any problem with Fannie Mae's cooperation in this examination call me directly. And I have received no such call. Now, the most inflammatory statement I guess is the one that says that the—that our cooperation was so bad that it required subpoenas to be issued and then subsequently the Justice Department was called upon to perhaps enforce those subpoenas.

First, with regard to the issuance of subpoenas, my attorneys were told by OFHEO staff that the issuance of subpoenas was not related to a lack of cooperation but that they were doing this simply to get people on the record.

Secondly, with regard to the Justice Department, both in-house and outside counsel for Fannie Mae spoke to the Justice Department about OFHEO's referral to it regarding enforcement of one subpoena relating to e-mail and the Justice Department indicated that this was an issue that they expected to be worked out between

OFHEO and Fannie Mae without any involvement of the Department or the courts.

So, with regard to our cooperation, I think it has been overwhelming. The subpoenas, as we were told, had nothing to do with lack of cooperation. And the Justice Department has indicated that they believe that this was an issue that could and should be resolved between OFHEO and Fannie Mae and it was resolved. All of the material requested by OFHEO has been provided to them.

Mr. LYNCH. Thank you. And thank you for clearing that up. Is there anything else you would want to add in terms of not a one-word answer, yes or no, but anything else that you feel that you need to clarify?

Mr. RAINES. There is one other point I would like to make, and it is an issue I think bears a broader discussion and that is the notion that in corporations there should be silos and that people should have one function, another function, and another function and they should never have any of these brought together. In fact, the practice of corporations is to bring together these things at a high level.

Mr. Howard is a vice chairman of Fannie Mae. He is one of the three most senior executives. So, of course he has many people who report to him. Otherwise, everyone would have to report to me and that wouldn't be a very functional organization.

So it is not unusual to have these reporting relationships. Indeed, there are many surveys that show that people bearing the CFO title quite often have risk management reporting to them, quite often have the balance sheet, the management reporting to them, quite often have internal audit reporting to them.

So, although it was characterized as being unusual, it is actually usual, and, in his role as the vice chairman, his duties are far beyond simply being the CFO, and it is quite appropriate that he have a large part of the company reporting to him.

Mr. LYNCH. Okay. Thank you, gentleman.

Thank you, Mr. Chairman.

Chairman BAKER. Mr. Toomey?

Mr. TOOMEY. Thank you, Mr. Chairman.

I would like to get to the specifics of one of the allegations with regards to FAS 91 in particular. As we all understand, FAS 91 deals with the methodology by which a firm is required to amortize premiums and discounts. In the case in question, I believe specifically the situation arises in which these premiums and discounts have to be amortized over securities that have prepayment features.

There are requirements under FAS 91, as I understand it, that you do the calculation, you then amortize a very precise amount quarterly over an assumed future remaining life of a given security, and then, when the next quarter comes around, you need to reanalyze this.

Interest rates very often will, in fact, be somewhat different than they were projected to be or assumed to be in the modeling in the previous quarter, and you then redo the amortization essentially.

You do this prospectively, but you also do it historically, so to speak, with an adjustment to the current quarter, which is in-

tended to capture the cumulative historical difference between what was estimated in the past and what reality has shown.

My concern and my understanding and the testimony of OFHEO is that FAS 91 requires that you come up with a precise number and that number be entered in that given quarter, and my concern is that you developed a policy whereby you did not use that number. You created a considerable discretion, in fact, over what number you would use within a range.

I would like for you to explain to me where it is in FAS 91 that you are authorized to not use the number that the model comes up with and confirm, if you will, that it is, in fact, that methodology about which KPMG said they have an audit difference with Fannie Mae.

Mr. HOWARD. Mr. Toomey, I would be happy to address that.

In estimating the rate at which we amortize premiums and discounts, one has to make a number of assumptions on——

Mr. TOOMEY. Understood.

Mr. HOWARD.——interest rates and prepayment sensitivities. By making assumptions that are reasonable but different, one can come up with different sets of very precise numbers, and I understand you have to choose one, and we do that.

So, when interest rates change, we will by practice reflect that new estimate in the rate at which we amortize purchases at the premium going forward because those adjustments take place over time.

Where we have used in the past a range or a threshold to determine at what point we have sufficient certainty around the estimates that we are making between the numbers that we recorded historically and the numbers a new set of assumptions would indicate we should have recorded historically, we have, as a matter of policy, since FAS 91 was first implemented, had some latitude around zero, typically plus or minus $100 million, but more than that.

Mr. TOOMEY. My point is, does FAS 91 authorize that?

Mr. HOWARD. According to our accounting policy team and KPMG, it does. KPMG——

Mr. TOOMEY. Then why does KPMG have a difference on that issue?

Mr. HOWARD. KPMG had a difference prior to 1998 because we did not have a defined policy in place that governed how much latitude we could have—let me finish, please—before we made an automatic adjustment.

Once we put that policy in place and limited the amount or the size of that range, KPMG removed its audit difference, therefore confirming our view that the treatment of this estimate retroactively—not prospectively, but retroactively—was, indeed, consistent with GAAP, and this is something that the SEC will look at, and they will give us their view.

Mr. TOOMEY. Yes. Oh, they will. But you have not cited anything in FAS 91 that says you are allowed to use a number other than what your model comes up with.

The other thing that raises concern about this is the exchange in memos between yourself and others seems to suggest that there was a conscious ongoing effort to manage this amount. This is a

large amount. $100 million on a quarterly report out of earnings of $1 billion or so, thereabouts, suggests a very substantial percentage of this.

Mr. HOWARD. Congressman, let me be very clear. My intent in getting involved in the development of the policy was to ensure that the numbers we were reporting to investors was as clear and as meaningful as they could possibly be.

I will give you an example of how I thought about this. For the five years from 1999 through last year, our net interest income averaged about $2 billion per quarter. Now investors are looking for changes in our net interest in come for evidence of how fast our business is growing.

A net interest income amount of $2 billion in one quarter, growing at 10 percent per year annualized, will be roughly $2.05 billion in a quarter. If we are growing at 15 percent annualized, it will be $2.075 billion. So the difference between 15 percent growth and 10 percent growth in a single quarter is $25 million.

If we adopt a policy that causes us to make these random adjustments based on our estimates of prepayments, collapsed over a number of years going back into a single quarter that is, say, $70 million, we have worsened the quality of our financial statements by adding a spurious number—this is our view. I am not asking you to agree with it—that is bigger than the discernment investors are trying to achieve in looking at our quarter-to-quarter financials.

I made the judgment. Accounting does not only permit but also encourages practical applications and judgments in financial reporting. This, in my view, was a good judgment because it preserves the integrity and the quality of our published financial statements.

Mr. TOOMEY. Well, I see my time has expired. I have to say I am very skeptical about this methodology, in particular this catch-up mechanism, this range, using this discretion in terms of how much income you show, and it is such a substantial portion of total income.

Mr. HOWARD. It is not discretion. Let me be clear: It is not discretion.

Mr. TOOMEY. Well, the report quotes people in your firm who describe it as discretion.

Mr. HOWARD. For a small period of time historically, we had discretion. After the policy was locked in the middle of 2002, there has been no discretion from that point forward.

Mr. TOOMEY. Well, you are directly contradicting what some people from your firm are saying in the OFHEO report in terms of the discretion that remained after the policy was adopted.

Mr. HOWARD. After the policy was adopted in December 2000, in the middle of 2002, we eliminated any potential for discussion by changing the policy. So we now have an agreement with KPMG that we will use no additional discretion in doing the FAS 91 amortization post December of 2002, and that is a fact. OFHEO may not have picked that up.

Mr. TOOMEY. So, since 2002, you have ceased and desisted using this methodology that you used before.

Mr. HOWARD. What happens is when our catch-up adjustment is within the size limited by the guidelines, roughly plus or minus 1

percent on net interest income and 2 percent on guarantee fees, we do not make any adjustments at all. So that is not discretion.

When it is outside that, we book to the edge of the range and no further. That is not discretion either.

Mr. TOOMEY. And the establishment of the range, the methodology and the amounts of these ranges, these were all developed and established by you. This is not under the direction of FAS 91.

Mr. HOWARD. Well, by the company.

Mr. TOOMEY. By the company.

Mr. HOWARD. Yes, that is correct. They are consistent with FAS 91.

Mr. TOOMEY. Well, that is what we are going to find, the SEC's opinion on that.

Mr. HOWARD. You are absolutely right.

Mr. TOOMEY. Yes.

Chairman BAKER. I thank the gentleman.

Mr. Baca?

Mr. BACA. Thank you very much, Mr. Chairman.

Let me ask this question of Mr. Raines or Mr. Howard, and either one of you can respond.

OFHEO has been the regulator since 1992. Is that correct?

Mr. HOWARD. Yes.

Mr. BACA. That is 12 years. During this 12 years, their responsibility is not only to audit you. Is that correct?

Mr. RAINES. Well, they examine us. They have an annual examination.

Mr. BACA. And during that examination, if they find any deficiencies, is it their responsibility to let you know of any deficiencies, methodologies or other that you are following that you should not be following? Is that correct?

Mr. RAINES. Yes, that would be their responsibility.

Mr. BACA. In this particular case, did they ever come back and tell you in terms of standard practices or procedures or deficiencies that you had to talk to either one of you two with regard to these issues?

Mr. RAINES. Yes, not until we saw the special examination report.

Mr. BACA. Isn't that a normal practice for any accounting firm or auditing firm, to basically sit down with the CEO or the chairman to discuss any deficiencies or procedures or process that they are not following? Is that normal standard?

Mr. RAINES. It is a standard, and we did sit down with them each year. In fact, their chief examiner met with our board and presented the results of their exam, and none of these issues were included in any of those exams over any of those years.

Mr. BACA. And in any of those years, did they ever sign off in terms of your methodology or procedures or methods that you used?

Mr. RAINES. Well, you might want to talk about the FAS 133 exam.

Mr. HOWARD. Yes. From what I can recall, when we implemented the process for FAS 133, along with the systems, OFHEO did do a review of those processes and systems and said that it met or exceeded safety and soundness standards.

Mr. BACA. That meant they had to have signed off, right? That said that you are following directions, and they did not come back and tell you that you needed to follow a different one or the methodology that you are using is now different. Is that correct?

Mr. HOWARD. I would not know how to characterize it. They would have to do the characterization. I can tell you what they did.

Mr. RAINES. But did they do it?

Mr. HOWARD. Did they?

Mr. RAINES. Did they come back and tell us to do something different?

Mr. HOWARD. No.

Mr. BACA. Okay. Thank you.

This morning, the regulators alleged that Fannie Mae did not respond to the initial request for information and that it had to issue a subpoena. Can you give us your version of the events leading to this release of the information?

Mr. RAINES. Congressman, we have been very responsive to OFHEO over this period, specifically relating to subpoenas. Our attorneys were told that the use of subpoenas did not relate to a lack of cooperation, but that this was because OFHEO wanted to move from informal interviews to having them on the record. That is what we were told at the time that the first subpoenas were issued because we said to them, you know, "There is no need for this. We will produce the people, and we will produce the documents." They said they wanted to move——

Mr. BACA. So you were willing to be cooperative with them and willing——

Mr. RAINES. We were willing and we were cooperative providing hundreds of thousands of pages of material and almost a million pages of e-mail to them as the result of their requests.

Mr. BACA. Did OFHEO personally contact you regarding the preliminary findings, either one of you?

Mr. RAINES. No.

Mr. HOWARD. Not me.

Mr. BACA. It seems odd that they would not contact you. Yet, you know, they have gone to the media and they have gone everywhere else. But yet they should have followed, practiced standard procedures, which is a total violation.

Maybe we should have them on the audit out here versus you guys in terms of not following practice or not following the laws that are in place.

Where do you think the process will go from here?

Mr. RAINES. Congressman, this process has been so unusual, I cannot tell you. I can tell you what we are doing.

Our board has negotiated an agreement with OFHEO, which we are going to faithfully follow and put into effect within the timeframes as agreed to between the director and our board.

We are also going to be cooperating with the independent counsel that our board has appointed to look into all of these allegations and to see if we can find out what the facts are, and so we will cooperate with them.

We will be attempting to take the two big accounting issues, FAS 91 and FAS 133, directly to the SEC and ask them to give us resolution on those so we can see, and, if we are right, then we are

right, and, if we are wrong, we will make whatever changes the SEC tells us to make, and we will also cooperate with any law enforcement agency that is attempting to look at these allegations.

They are very serious allegations, they have to be looked at, and I am delighted that today, for the first time, we are allowed to at least partially give our point of view. But, certainly, the independent counsel will be looking at every document and every person and doing a very thorough review, and we look forward to that.

Mr. BACA. Thank you.

I served on numerous boards, and, usually, when an audit is done by any accounting firm, they usually come up with the recommendations, the deficiencies, recommendations for improvements.

You usually give that nonprofit organization an opportunity to correct those deficiencies before any kind of action is taken, and I am just really appalled at the kind of action that has occurred out here without first discussing it with either one of you two in terms of any corrections or actions that need to be taken. If there was a difference in terms of methodology, accounting system, what needed to be done, it seems like they would have approached you.

So, hopefully, we will comply with both the laws that are in place right now in terms of standard practices that need to be done.

And, Mr. Chairman, I realize that my time has expired, but thank you very much.

Chairman BAKER. Mr. Bachus?

Mr. BACHUS. Thank you.

Chairman Raines, we are talking about these financial reporting issues in a lot of the discussion, whether, you know, you violated FASB rules or not, but did these issues, I mean, first, undermine your creditworthiness?

Mr. RAINES. Well, I have to say, Congressman, that since this report has come out, we have been put on credit watch, and one of our credit ratings was dropped, went down as a result of this report.

So a report like this from a regulator has serious consequences in the capital markets. You know, our stock price dropped by $14 billion as a result of this report coming out in the way it did.

So, yes, this report has a very, very big impact on how we do our business from our debt costs to our credit ratings to our stock price.

Mr. BACHUS. Okay, but you are not in jeopardy of meeting your ordinary course of business, your obligations and that?

Mr. RAINES. No, the fundamental economics of the company has not changed.

Mr. BACHUS. Okay.

Mr. RAINES. The company is in fine shape. The only thing that has changed is this report.

Mr. BACHUS. Yes, when creditworthiness changes, your credit rating changes, you are put on credit watch. Obviously, that has implications not only for the housing market, but for the general economy as a whole.

Mr. RAINES. Yes.

Mr. BACHUS. I think what we had discussed this morning is you heard Director Falcon say you all were uncooperative, but you have

rebutted here pretty clearly, and, you know, so we have a difference of opinion on that.

The other thing, which a gentleman just mentioned, is he says he used best regulatory practices in this special investigation. You have been in government business for a long time. Is this normal? Is this the best practices for other government regulators? How would they have typically handled things as opposed to how OFHEO did?

Mr. RAINES. Well, Congressman, when I was in the government as the director of the Office of Management and Budget, one of my duties was to oversee regulatory matters throughout the federal government, and I have never seen a proceeding like this. In all of my time, I have never seen a proceeding like this.

The financial regulators are given special powers, very, very strong powers. They can put a financial company out of business if they choose to. And because they are given those special powers, they exercise them very carefully.

Quite typically, a financial regulator in this circumstance, taking everything OFHEO has said at face value, as being true, that financial regulatory would have managed this without one headline, and they would have done it entirely confidentially.

They would have resolved the issue, and, at the end, the resolution would have been announced, and this has happened many times. The Fed, the OCC, the OTS have had to do this with financial institutions.

So, if we take everything they said as being exactly right, I do not know of any financial regulator who would have done it this way. I have never heard of a special examination report being made public.

Mr. BACHUS. Well, it certainly has been on the public stage, the entire process.

CFO Howard, do you want to comment?

Mr. HOWARD. No.

Mr. BACHUS. Oh, okay. I am sorry.

Let me ask you this. You know, you all have basically said that most of what they have, I think, accused you all of doing you had not done or that they had not, at least before now, asked you to change your internal controls, very strange, and you are defending your practices, I think, by and large.

That being the case, why did you all enter into this September 27 agreement? I mean, you know, if they were not right, why would you have sort of consented to do what they asked you to do? And I know that you did not acknowledge any wrongdoing, but you took some pretty drastic measures, and one might say, "Why would you have done that?"

Particularly, one thing you have done is you have agreed to this capital surplus of 30 percent of minimum capital reserve, which if followed could, you know, restrict your activities which could negatively impact the financial markets. So I would just say is there an explanation for that.

Mr. RAINES. Well, yes, there is. Our board gave tremendous consideration to this, and there are several points, I believe, that they wanted to make.

The first point was to acknowledge that we are a regulated company, and, if our regulator has concerns, whether we agree with them or not, they have to be taken quite seriously. So they wanted to demonstrate that on every issue they could agree to that they would reach an agreement.

Second is that the agreement preserves the issues on which we do not agree, and those are to go to the appropriate place.

Third is that we are mindful of the markets, and the idea that a company as large as we are would be seen to be having some kind of ongoing battle with their regulator struck us as to be contrary to our mission, and we did not want to take the risk of undermining our mission by appearing to be in an ongoing battle with our regulator.

So the board had to make a judgment. I know some people took that agreement as being an admission of guilt. I think it was a demonstration of leadership by our board that put our mission first as opposed to our reputations or our feelings or our gut, all those other things that they could have put first. They put the mission first, and I think that is admirable, and I applaud them for doing it.

As I mentioned before, financial regulators are very powerful entities. They can put you out of business, and so it is imperative for the board to ensure that we have a functioning relationship with our regulator on an ongoing basis.

Mr. BACHUS. Can I——

Chairman BAKER. Can you wrap up? Yes, sir.

Mr. BACHUS. This is my final question. This will be for you, CFO Howard.

Can you outline for us the exact steps that must be followed under FAS 133 for a derivative contract to receive hedge treatment and also whether Fannie departed from common industry practice in establishing an effective hedge?

Mr. HOWARD. We, first of all, do not believe we did depart from practice, and, importantly, OFHEO has not contested the fact that the transactions that we have entered into are economically effective.

Mr. BACHUS. Right.

Mr. HOWARD. What they are talking about is whether we have met the criteria for hedge accounting. The requirements differ according to the nature of the transaction.

For the derivative transactions at issue, you must first identify the transaction as being a certain type of hedge, with documentation. We believe we have done that. OFHEO has raised some questions over technicalities around the documentation.

The second thing that has to happen, again, in types of transactions we have undertaken, is we need to have a high degree of effectiveness. It is called in the literature "perfect effectiveness," which can be assumed. We have assumed perfect effectiveness on these hedges because, in our view, that we have buttressed by periodic testing, there is a very, very small amount of ineffectiveness.

Even though I recognize that minimal ineffectiveness and perfect effectiveness are not the same thing, our reading of the accounting literature, buttressed by KPMG notes it is making a practical ap-

plication in a business context that is permissible, and that is what we have done.

Mr. BACHUS. Well, then it is my understanding that there is no question that any of these activities undermine the safety and soundness. In fact, some of them are prudent business practices except where they may have violated, you know, financial reporting standards.

Mr. HOWARD. And we do not think we have.

Mr. BACHUS. I think that is really the issue, not whether you have engaged in any dangerous——

Mr. RAINES. Right. In fact, these hedges are all designed to reduce risk.

Mr. HOWARD. Exactly right.

Chairman BAKER. The gentleman's time has expired.

Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chairman.

Mr. Raines, Mr. Howard, this may come as a surprise to you, but some people just do not like Fannie Mae's current status in the market, and that is pre-this OFHEO's report, et cetera. In fact, this may be a surprise, that when OFHEO came here—and Mr. Falcon—once before, many members of this Congress criticized them severely and threatened to put them out of business, in fact, wanted a new regulatory agency to come in.

You know, I understand your statements, Mr. Raines, about you do not understand certain things, but let me just let you in on a surprise. Some people do not want you in business. They do not like the success that you have accomplished by putting people with decent homes and roofs over their head. Some people just do not like that. And so that might be a surprise to you.

In fact, let me ask. Prior to this hearing that we had where OFHEO was threatened, had there been an occasion or any time before where OFHEO may have examined Fannie Mae and noted any irregularities or discrepancies in any kind of accounting standards?

And I wonder how did they work with you in the past before we had all of these secrets coming out that people do not like what you do?

Mr. RAINES. Well, prior to the issuance of this special examination report, all of our examinations from OFHEO found that we met or exceeded safety and soundness standards, and that is going back to when OFHEO first organized itself back in, I think, 1993.

So we had never, to my knowledge, had an outstanding issue with OFHEO on accounting, internal controls or any other issue. In the course of their examinations, they would make recommendations to us and, you know, we would adopt them. But we have never had an issue prior to this examination report.

Mr. MEEKS. Were you willing to make those? When OFHEO was making those recommendations, et cetera, in the past, would that have been shared with the press or members of Congress or put in the headlines of the newspapers? Has that ever happened before?

Mr. RAINES. No, the examination reports remain confidential until OFHEO makes an annual report to Congress, usually released in June, and then it is made available, but all of the examinations are held confidential, and, in fact, OFHEO has a regime for

their regular examination function that holds these things confidential, and we have had very good experience with their regular examination process in that regard.

Mr. MEEKS. So this is a relatively new phenomenon that has taken place now as far as your relationship with your regulator.

Mr. RAINES. With regard to this special examination, this is very new.

Mr. MEEKS. I know that you have indicated in your testimony thus far that your board, I understand, had agreed to the 30 percent capital surplus because you want to show, you know, you are part of the market and that you are cooperating, et cetera.

But I am curious to know is there any other financial institution that does anything even close to 30 percent.

Mr. RAINES. As a mandated surplus? Well, Freddie Mac has a——

Mr. MEEKS. Other than Freddie Mac.

Mr. RAINES. No, sir. I am not aware personally of a financial institution that is otherwise solvent that is required to have a mandatory surplus by their regulator, but that is not to say it does not exist. I am just not aware of it.

Mr. MEEKS. And, Mr. Howard, let me just ask you a question. This will be my last question—and I will yield back the balance of time—because I am just trying to make sure that I understand.

According to OFHEO, Fannie Mae must supply FAS 91 by recognizing only $200 million against expenses for prepaid loans, instead of $400 million, and, of course, you state that Fannie Mae's treatment was correct and that KPMG agrees with you. Just explain to me why are you right and OFHEO wrong.

Mr. HOWARD. Prior to 1998, you know, any amount of this so-called catch-up adjustment, which, again, was the comparison we made after the fact between the amount that we had brought into income based on an old assumption of average life of the portfolio—remember there are millions of loans in the portfolio—and a new average life. That difference we had kept track of but never recorded in current period income. That was the catch-up adjustment.

In 1998, that dollar amount grew to a large size of expense—it was actually closer to $440 million—and we determined that some portion of that likely did represent a true economic cost. So we put together a group within the finance department of portfolio people and comptroller's people to come up with a method of determining the best amount to best reflect true economic substance.

The recommendation they made to me and to us as the senior management team was that $240 million was that right amount. So the remaining amount, which was not deferred because it was an amount that never was recorded on the books in previous years—it was kept track of, and that was the audit difference—that turned out to be a judgment that ex-post proved to be correct because next year we did not have an audit difference that was expense. We had one that was income.

So the judgment in retrospect turned out to be correct. It was made as a part of a process that had integrity, and it was independent of any link to compensation.

Mr. MEEKS. Thank you.

Chairman BAKER. The gentleman's time has expired.

Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Raines, I have a lot of respect for you. I think that you are one of the best budget directors. You are very articulate. I liked your opening statement, the buck stops with me. We do not hear that enough, and I thank you for that.

My problem with Fannie Mae is I feel it is a bully in the marketplace that exercises its incredible advantages and does not want to play by the same rules that everyone else plays by, and I think you know that is what I think.

I think that your not being under this 1933 Act and then voluntarily agreeing to be under the 1934 Securities Act—voluntarily—to me is a bit arrogant. I think you should be willing to be under those laws.

I think to suggest that you should have a weak regulator like OFHEO, and, when we wanted to strengthen it, you had objected to strengthening it, I have a problem with that.

So I am not surprised by what is happening right now.

When you say, "Well, OFHEO never did this before, and we played by their rules," they were a very weak regulator.

I am not pleased to learn that you have given $245 million worth of bonuses in the last five years. That is aside from stock options. So I have a bit of a problem with that.

But I am particularly curious as to why OFHEO needed to have subpoenas in order for them to do their job. Why did they have to get subpoenas? So, if you would just tell me that, I would start off with my questions with that.

Mr. RAINES. Well, I will just answer your subpoena question.

Mr. SHAYS. Yes.

Mr. RAINES. There are a lot of other things there, but——

Mr. SHAYS. I know that, but that is my time. You have had your time.

Mr. RAINES. With regard to the subpoenas, our lawyers were told by OFHEO staff that they were issuing subpoenas not because of any lack of cooperation by Fannie Mae, but because they wanted to move the interviews from being informal interviews to interviews on the record with someone there keeping a record of exactly what was told. That is what we were told contemporaneous with the issuance of the subpoenas.

Mr. SHAYS. Can I just say to you I am a little concerned with that answer because it seems to conflict with what we had been told. So I just—and you are under oath—want to make sure.

Are you suggesting that there was no requirement whatsoever for them to get subpoenas, that you, as soon as they asked for this information, you, Fannie Mae, voluntarily provided this information? Is that your testimony?

Mr. RAINES. That is my testimony.

Mr. SHAYS. Is that your testimony, Mr. Howard, as well?

Mr. HOWARD. To the best of my recollection, yes.

Mr. SHAYS. Okay. To the best of your recollection. In other words, this information was asked for, and you voluntarily were going to provide it, but, instead, they said, "Oh, by the way, we want to go and get subpoenas."

Mr. RAINES. We were actually in the process. We had been doing this for quite a while. The special exam had been going on for a while before the first subpoena was ever issued. We had been providing thousands of documents, providing people, providing e-mails.

Mr. SHAYS. Okay. Did you provide the information they wanted, not what you wanted?

Mr. RAINES. Yes. We had provided every piece of information they wanted, and we told them they would get that with or without subpoenas.

Mr. SHAYS. Okay, but I think it is important to put on the record because the information is that they had to get subpoenas to get this information.

Mr. RAINES. Well, I have testified very clearly that that is inaccurate.

Mr. SHAYS. Okay. Let me ask you, besides the bonuses, you offer stock options as well?

Mr. RAINES. We are a shareholder-owned company, and we pay according to what our statute provides, which——

Mr. SHAYS. Is that a yes?

Mr. RAINES. We pay comparably to other companies, and we use stock options among the various things in our executive compensation.

Mr. SHAYS. Do you dispute the amount of $245 million over the last five years as bonuses? That is a lot of money. It is a quarter of a billion dollars. Nodding the head does not get transcribed.

Mr. RAINES. Well, I have to go calculate the number. It is a number that is calculable, and I do not know what the number would be.

Mr. SHAYS. Do you think it is in the ballpark?

Mr. RAINES. It could be.

Mr. SHAYS. Yes.

Mr. RAINES. But you say it is a very large number. In the last five years, we have also probably had after-tax income of $30 billion. So our executive compensation——

Mr. SHAYS. I know you are a very successful company.

Mr. RAINES.——is a tiny, tiny percentage of our revenue, and it is a tiny percentage of our profit.

Mr. SHAYS. Why should banks have to set aside between 6 percent and 8 percent of their portfolio and you guys are in the range of about 3 percent?

Mr. RAINES. Banks should do that because they have much more risky portfolios. Banks are allowed to invest in a wide range of assets. We can only invest in single-family and multifamily homes.

Mr. SHAYS. So it is your testimony that you do not need to have more because you do not feel any of your investments potentially could go sour?

Mr. RAINES. If none of them would go south——

Mr. SHAYS. No, you set aside a certain sum in case the market starts to go bad, and the residential marketplace is very volatile, and you have about 3 percent of your portfolio set aside. If a bank gets below 4 percent, they are in deep trouble. So I just want you to explain to me why I should be satisfied with 3 percent.

Mr. RAINES. Because banks do not—there are not any banks who only have multifamily and single-family loans. I think if you check,

banks are now arguing that their capital for those loans should only be 2 percent or less. I mean, that is the argument they are making right here in Washington today, that these assets are so riskless that their capital for holding them should be under 2 percent.

Mr. SHAYS. Fine, but let me just ask you this question because OFHEO was asked this. Before OFHEO issued its report, did any of you speak to any people in the press or with any members of Congress about their report?

Mr. RAINES. We did not know anything about their report. We had never seen their report.

Mr. SHAYS. When did you see their report?

Mr. RAINES. We saw their report on Monday.

Mr. SHAYS. Did you know of the report? Did you know the contents of the report?

Mr. RAINES. No, we had no knowledge of the content of the report. In fact, I had been calling the director. I had a meeting scheduled with the director to discuss the progress on the special examination, which he canceled. I had three calls into him to discuss it because of the press reports that we had seen, and I never talked to him.

Mr. SHAYS. I thank the chairman. Just to verify, we are not playing a word game here of a draft of the report.

Mr. RAINES. The report was handed to management as OFHEO officials walked into a meeting with our board, literally handed to us as they walked in.

Mr. SHAYS. And you were not given a draft earlier or a working draft or anything like that?

Mr. RAINES. We saw nothing.

Mr. SHAYS. So the answer to your question is you never spoke to any member of Congress before this report was issued or the press about this report before it was issued?

Mr. RAINES. About the contents of the report?

Mr. SHAYS. About the report.

Mr. RAINES. Well, if we are going to be this—we never saw the report!

Mr. SHAYS. I did not ask that. I want an answer to the question because I had been told that Fannie Mae had been speaking to reporters and press about this report before it was issued.

Mr. RAINES. About the content? Is that what you are asking? The content—are you—I want to be very clear here.

Mr. SHAYS. Not the content. Just concerns that there was going to be a report that came out, et cetera, et cetera, et cetera, and——

Mr. RAINES. We have talked about concerns. Yes, we have talked about concerns about the report that we had been reading about in the paper. Yes, indeed. The press was calling us. When they were reporting OFHEO is about to do a report, they asked us, "What is your reaction?" and we said, "We do not know anything about that."

Mr. SHAYS. And that is the extent of your contacts? You did not initiate any?

Mr. RAINES. Why don't you give me the example and then I can tell you what——

Mr. SHAYS. No, no. I do not want to give an example. I do not want to give you an example. I want to know if you all affirmatively went out to the press to engage them in a dialogue about this report which you say you have not seen.

Chairman BAKER. And that will have to be the gentleman's last question because your time has expired.

Mr. SHAYS. The answer is a yes or no. Did either you or your organization do that?

Mr. RAINES. Look, I do not understand what you mean by engaged. No doubt——

Mr. SHAYS. No, you do not want to answer the question.

Mr. RAINES. No doubt we talked to the press about the report we had not seen. No doubt that someone in Fannie Mae talked to the press about a report we had not seen because we were getting asked questions about a report we had not seen. Some questions indicated that they knew more than we did.

Mr. SHAYS. And the question I asked, though, which you could be responsive to—and I would appreciate it—is: Did you affirmatively interact with the press or actively contact the press about this report, not respond?

Chairman BAKER. And that is the gentleman's last question.

Mr. RAINES. I am not trying to be difficult.

Mr. SHAYS. The answer is a yes or no.

Mr. RAINES. I am not trying to be difficult, Congressman, but you are asking me the question, did we ever call a reporter and mention it? Probably, but not because we had seen the report.

Mr. SHAYS. Thank you. I hear you. I hear you.

Mr. RAINES. Okay.

Chairman BAKER. The gentleman's time has expired.

Ms. Waters?

Ms. WATERS. Thank you very much.

I just wanted to clear up a little something here. I find the information about the bonuses very interesting, and I am sure that it will cause a lot of discussion, but that is not really why we are here today.

You raised a question earlier, Mr. Raines, about this being proprietary information. Do you still think that this is proprietary information that has been released, after you have seen what we have?

Mr. RAINES. My concern about proprietary information solely goes to not the five people at the top because our information is public, but we have people trying to recruit away our people every day. Every day, we have recruiters coming to Fannie Mae trying to recruit our people away.

This is a road map as to how to go about recruiting Fannie Mae employees. This is private information about people who are not public officials, who are not senior officials, and now this is being made public for reasons I do not understand.

Ms. WATERS. Well, the reason that I asked is that our chairman did indicate that he had a legal opinion. I do not have a copy of that legal opinion. I do not think there is anything in writing. I think that his conclusions were drawn based on some constitutional reference.

I just wanted to make sure that it is your understanding that it is proprietary information so that I can continue my follow-up and my investigation to find out whether or not proprietary information has been released. But you do think it is proprietary?

Mr. RAINES. My only goal here was to not waive any rights we have.

Ms. WATERS. All right.

Mr. RAINES. We continue to maintain whatever rights we have asserted. I did not want to waive that by sitting here and not saying something that was being revealed.

Ms. WATERS. Okay. That is fine. And I think I know what to do with that.

I know you have repeated this any number of times, but I think it is very important for you to repeat part of an answer that you had given earlier, relative to this business about subpoena and information from OFHEO about you had been forced somehow to answer questions.

Part of your information had to do with the Justice Department and the fact that they had been contacted. What was the Justice Department's response to OFHEO's request to be involved in this in some way?

Mr. RAINES. The Justice Department response was that they indicated that this was an issue that they expected to be worked out between Fannie Mae and OFHEO and that they did not believe that there was a need for any involvement of the department or the courts in working it out.

Ms. WATERS. Excuse me one second, my colleague, Mr. Shays? My colleague, Mr. Shays?

The question that you asked about whether or not they had been forced through a subpoena to cooperate or to answer questions, there was one portion of his answer that you were not privy to. You were not in the room. I just asked him to repeat it. You were being distracted. I would like to ask him to report that again.

The Justice Department had been contacted to ask to be involved in some way with this investigation. What did the Justice Department say, Mr. Raines?

Mr. RAINES. Let me read to you specifically so you have the statement that has been approved.

"Both in-house and outside counsel for Fannie Mae spoke to the Justice Department about OFHEO's referral to it regarding enforcement of one subpoena relating to e-mail, and the Justice Department indicated that this was an issue that they expected to be worked out between OFHEO and Fannie Mae without any involvement of the department or the courts."

Ms. WATERS. Okay. Thank you very much.

I also would like to inquire——

Mr. SHAYS. I do not know what that means. I do not know what the means, so if you would——

Ms. WATERS. Okay. On my time now.

Mr. RAINES. I think what that means is——

Ms. WATERS. Excuse me. This is my time. You may not answer him on my time. He can get some additional time.

Let me just ask you is it true that you absolutely had not seen this report until they came to the boardroom with the report.

Mr. RAINES. That is true. I did not see the report until they went into the boardroom, and they then handed a report with my name on it, an envelope with my name on it, saying, "This is your copy of the report."

Ms. WATERS. Were you ever told why it was important to come before the board with such haste? From the time the report supposedly was finalized and to the time that they came to the boardroom, did you ever hear why it was so important to get that board organized so that they could receive this report? Were you ever explained to why it happened that way?

Mr. RAINES. It was not explained to me. I can believe you are going to have our lead director testifying before you. She can also answer whether it was ever explained to her.

Ms. WATERS. Did you ever hear that the timing of the board meeting had anything to do with the fact that there was a desire to have this hearing prior to the recess—congressional recess? Did you ever hear any of that discussion?

Mr. RAINES. I did not hear that.

Ms. WATERS. All right. Finally, let me just ask you this.

Obviously, Fannie Mae is a very sophisticated organization with a lot of smart people doing big, big business, and it is—I cannot understand why you would be involved in any activity that could easily be unveiled that was incorrect accounting practices or anything else with some kind of investigation. You have testified as to your accounting practices and your understanding of what is expected of you.

Finally, when Fannie Mac was investigated, did this raise some kind of red flag, and, even though you felt that what you were doing, you were doing it correctly, that you were on solid ground, did you say, "Well, let us look at ours again, too, to see if there is anything here." I mean, I would have done that, and I want to know did you two did that?

Mr. RAINES. We did, indeed, do that. We engaged outside counsel, we engaged accounting, we looked at everything that was alleged about Freddie Mac to see did Fannie Mae have the same problems, and our conclusions were that we did not, and, to this day, no one has alleged that we had the same problems that Freddie Mac had. These issues that are in the OFHEO report are brand-new issues to Fannie Mae and they are new to our relationship with OFHEO.

Ms. WATERS. And, by the way, I am going to ask you something that you may not want to answer.

Since all of this has been made public, I read an editorial in The Wall Street Journal that talked about the fact that there had been an investigation and that editorial almost jumped to the conclusion that there must be something wrong, and, therefore, the investigation, even though there had not been a response, there must be something wrong, and even though they did not explore it fairly, they came to the conclusion that you would not be fit to be the treasurer of the United States of America.

What does the speculation about your being perhaps asked at some point in time—should certain people win the presidency, what does that have to do with your work now have to do with whether

or not you should be asked to be the treasurer of the United States of America. Have you heard that discussion at all?

Mr. RAINES. I have heard that discussion. As you know, I have been around this town a long time. It is very said. It is very sad to me if any consideration of politics goes into something like this. My service in the government, you know, has been, I think, service.

You know, I have never run for office, and I have never sought to be a political figure. You know, I have responded when a President of the United States has asked me to respond, and that—I have been asked twice and I have responded twice to that case.

More than me, my colleague, my former boss, Jim Johnson, has been brought into this, and let me say something about that directly. He, too, has been mentioned as a potential person to be in a future administration. We have done a look at the 1998 incident that has been alleged by OFHEO, and we have found no acts that would relate to Jim Johnson whatsoever.

Indeed, he was not the CEO when these decisions were made. I was. And so any implication that Jim Johnson had something to do with this is just totally without factual base. It shows what happens in these kinds of frenzies.

I have to tell you the thing that bothers me far more than this treasury thing—far more—is explaining to my kids. That is hard.

Ms. WATERS. Well, I——

Mr. RAINES. It is hard when your daughter feels she needs to say to her dad, "I support you." I am supposed to be supporting her. That is hard.

Ms. WATERS. Well, we are going to be out of here when we go on recess, and all of this talk is going to fester. You have not had an opportunity to respond.

You have not been questioned. You have not had an opportunity to explain. Most of the members up here on this panel do not understand accounting practices. They are learning a lot for the first time today.

What this could potentially do is in some way damage your reputation because these allegations are being made without your having an opportunity to respond.

Chairman BAKER. Ms. Waters, your time has long expired. Can you wrap up, please?

Ms. WATERS. Yes, I will wrap this up. What would you ask this committee to do in the interest of fairness that would in no way accept OFHEO without the opportunity for the kind of response that is always allowed in this kind of setting? What would you ask this committee to do?

Mr. RAINES. Ms. Waters, what I would ask the committee to do is to insist with all the agencies within your oversight they operate within——

Chairman BAKER. Excuse me.

Ms. WATERS. I was trying to hear him.

Chairman BAKER. I thought your time had expired. Please proceed.

Ms. WATERS. Yes.

Mr. RAINES. What I would ask this committee to do is to insist for all the agencies within your oversight that they operate under the commonly accepted rules of due process and fair play. I would

also like your support to get a resolution on these issues that the SEC would give us an answer.

You know, we did not come here to say today we are perfect or even that we know that we are right. We are simply saying we approach this with a businesslike approach, with honesty and integrity, and if we are wrong, we will make the changes. If we are right, you know, then we will go forward.

All we have asked is that the proper process be used. The answers will come out of the proper process. That is the only request that we are making, is that at least give us the minimal rights that we would expect to be given to any other company, to any individual, any organization.

Chairman BAKER. The gentlelady's time has long expired. We do have a number of other members wishing to be heard.

Mr. Ose?

Mr. OSE. Thank you, Mr. Chairman.

Mr. Howard, am I correct in understanding you are the chief financial officer for Fannie Mae?

Mr. HOWARD. Yes, you are.

Mr. OSE. Am I correct in understanding that questions of how to treat income or expense at Fannie Mae—that decision would at least go through your office?

Mr. HOWARD. It would typically be discussed with me, depending on the level of importance.

Mr. OSE. At what level of importance do issues come to your office for a final determination?

Mr. HOWARD. That determination is made by the people who bring them to me.

Mr. OSE. Is there typically a threshold dollar amount?

Mr. HOWARD. No. It is usually how unusual, new the issue is.

Mr. OSE. In terms of such unusual or new situations, are you the final arbiter of such decisions?

Mr. HOWARD. Again, it is situational. In some cases, it could be the chairman, whoever that may have been, it could be me.

Mr. OSE. Now I recognize that the report in question today covered a period prior to Sarbanes-Oxley being in effect.

Mr. HOWARD. Yes.

Mr. OSE. Is that your understanding also? So it predates our passage here on the Hill of that particular——

Mr. HOWARD. Parts of it do. Yes, that is correct.

Mr. OSE. All right. Does the audit committee of the board of directors get involved in these questions?

Mr. HOWARD. Which questions?

Mr. OSE. Questions of a new or unusual set of circumstances having to do with how to treat income or expense.

Mr. HOWARD. Again, it would depend on the situation. Sometimes they are briefed on it. They are typically not consulted for a decision.

Mr. OSE. The audit committee is not consulted for a decision of any nature related to this kind of a situation? It is just given to them as a fait accompli?

Mr. HOWARD. It is. I am attempting to recall an instance where the audit committee may have been consulted in advance on a financial decision. I cannot recall one.

Mr. OSE. So, in effect, what you are saying is that the audit committee does not set the standards for the decisions. The recommendation is given to them and they will either say yea or nay?

Mr. HOWARD. Well, no, we typically do not even do that. We will report on the financial condition of the company, significant accounting issues. Anything that we think ought to be brought to their attention for review, we will bring to them.

They can comment on them, they can ask us to do things differently, but we do not ask them for a decision because they typically do not have the level of expertise to make decisions at that level of detail.

Mr. OSE. I just want to make sure I understand it. Implicit in your answer is that such decisions are therefore made at the management level, rather than the board level.

Mr. HOWARD. That is correct.

Mr. OSE. Okay. So the final arbiter for such decisions is your office?

Mr. HOWARD. It, again, depends on the decision. It could be the comptroller. It could be the level below the comptroller. It could even be at a level below that.

Mr. OSE. So the decisions may be made within perhaps the operating units of Fannie Mae.

Mr. HOWARD. Not accounting decisions. They would not be made within the operating units. Accounting policy decisions are made by the accounting policy person, transactional decisions that have accounting ramifications are made in the units, but the results are reviewed and assessed by people in the comptroller's department.

Mr. OSE. And then they are run past you as CFO for final signoff or rejection.

Mr. HOWARD. It depends on the issue. Most of them do not come to me for that step.

Mr. OSE. Mr. Chairman, we may have the wrong guy here to ask these questions on the accounting rules or modifications.

I am curious whether or not you do play a role in making decisions as to what is or is not treated as an expense in one case or an income issue in another.

Mr. HOWARD. Typically not.

Mr. OSE. And you are also testifying that the audit committee of the board of directors is not involved in those decisions either.

Mr. HOWARD. Not asked to make them. Informed of them.

Mr. OSE. Now you are CFO. Am I correctly advised that you are CPA trained?

Mr. HOWARD. You are incorrectly advised. I am not a CPA.

Mr. OSE. You are not a CPA. Okay.

Let me ask a different set of questions, if I might. Actually, this goes to Mr. Raines. Prior to this hearing, did you or any of your agents or employers or counsel visit with any members of this subcommittee about the substance that we were going to discuss here?

Mr. RAINES. Yes.

Mr. OSE. Did you or any of your agents or employers or counsel provide questions to members of this subcommittee for the purpose of having those questions posed to witnesses during this hearing?

Mr. RAINES. I believe we talked to members about or staff about questions that they might want to pose, yes.

Mr. OSE. Okay. The only reason I ask that question is that Mr. Falcon, I think, was asked on the previous panel to provide to the committee a record of all such contacts that he may have had with the committee or his agents or employees. I am asking: Will you provide the committee a similar record of all such contacts to this committee regarding this hearing?

Mr. RAINES. My answer is I do not know. I mean, we will have to talk to our counsel and others.

Mr. Falcon is a government employee. He is running a government agency. There are laws that relate to the ability of a government employee to lobby the Congress, and I assume that that is what the inquiry was to Mr. Falcon.

We are not a government agency. We are not prohibited from lobbying the Congress, but I would certainly take under advisement your request, and we will get back with you with an answer.

Mr. OSE. I am going to take that as a no, Mr. Chairman. Thank you.

Mr. FRANK. Mr. Chairman?

Chairman BAKER. Yes, Mr. Frank?

Mr. FRANK. Mr. Chairman, we have a colleague now on the committee, the gentlewoman from Florida, Ms. Brown, who is very interested in this and a student of Fannie Mae and its activities, and I would ask unanimous consent that she be allowed to enter a statement into the record of this hearing.

Chairman BAKER. Without objection.

Mr. Davis, you are recognized.

Mr. DAVIS. Thank you, Mr. Chairman.

Mr. Raines, I had planned to go in a different direction, but I want to follow up on Mr. Ose's comments for a moment. You have been in D.C. for how many years as a——

Mr. RAINES. I have lived here for about 20-some-odd years.

Mr. DAVIS. Okay. But in terms of your work at OMB and your work at Fannie Mae, you have been a part of the institutional layers in this town for a while, have you not?

Mr. RAINES. Yes, sir.

DAVIS; And you have seen your share of congressional hearings, I assume, over the course of time?

Mr. RAINES. Yes, sir.

Mr. DAVIS. Is it a fairly common practice, Mr. Raines, for almost every single entity that comes before this committee to have some consultation or talk with members of Congress or staffers before their folks testify?

Mr. RAINES. Yes, sir. I typically did that when I was in the government, and I have done it since I have been out of the government.

Mr. DAVIS. And that is not an unusual or insidious practice in any way?

Mr. RAINES. No way.

Mr. DAVIS. And just one final point on this: You were asked by Mr. Ose if you or Mr. Howard had talked to your attorneys. Are you aware from newspaper reports that there is a Department of Justice probe in this matter?

Mr. RAINES. I am aware of that from the newspapers.

Mr. DAVIS. And based on your professional experience, Mr. Raines, is it not commonplace that if someone is a potential subject even, much less a target, of a Justice Department probe that they would probably be out of their mind if they did not talk to a lawyer?

Mr. RAINES. Yes, sir. You are right.

Mr. DAVIS. And especially if you are about to give public testimony under oath, wouldn't the prudent thing be to talk to a lawyer?

Mr. RAINES. Yes, sir.

Mr. DAVIS. Okay. Let me move to a much more important set of questions. One of the things that OFHEO is criticizing, as you know, is the structure of management at Fannie Mae, and they are questioning the structure of responsibilities, and there is some argument that there should be a greater separation of certain job descriptions.

Mr. Howard, you understand that is one of the subjects here.

Mr. HOWARD. I do.

Mr. DAVIS. How long has OFHEO been in existence?

Mr. RAINES. The Congress created them in 1992. They actually, I think, came into existence in 1994.

Mr. DAVIS. Okay. The structure that they are questioning or raising issues about—how long has it been in place at Fannie Mae?

Mr. RAINES. A version of the current structure has been in place since 1991 when I joined the company.

Mr. DAVIS. Okay. At any point prior to September of 2004 has OFHEO raised any questions about the structure or the alignment of job responsibilities at Fannie Mae?

And I will ask both of you that question.

Mr. RAINES. Not to my knowledge.

Mr. DAVIS. Mr. Howard?

Mr. HOWARD. Nor to mine.

Mr. DAVIS. And, as far as you know, has OFHEO been aware of that structure for the whole 12 years of its existence?

Mr. RAINES. Yes, sir.

Mr. HOWARD. It could have been.

Mr. DAVIS. And has OFHEO given you any explanation of why they did not raise questions in the previous 12 years?

Mr. RAINES. No.

Mr. HOWARD. No, sir.

Mr. DAVIS. Does it suggest to you the fact that if they did not raise questions in the previous 12 years, they probably did not think it was a matter worth questioning?

Mr. HOWARD. I do not know.

Mr. RAINES. That would be speculating. They asked us lots of questions over the period of time, and, as far as I know, this has not been an issue with them.

Mr. DAVIS. Neither of you was in the room when I had a chance to question Mr. Falcon earlier, but I want to ask you for a reaction to some observations that I made.

As I understand OFHEO, their task is to oversee the safety and soundness of Fannie Mae. Am I correct in that understanding?

Mr. RAINES. Yes.

Mr. HOWARD. Yes.

Mr. DAVIS. One of the concerns Ms. Waters has raised, that I have raised and other members of the committee have raised is that it appears that OFHEO has crossed some line into simply being a neutral and dispassionate analyst or neutral and dispassionate observer of what the institution does, to having a very strong set of opinions about the institution.

Is that the impression the both of you have?

Mr. RAINES. Congressman, I think that there has been an evolution in their thinking that they believe that they either have the authority to or have the need to be more directive as to how we carry out our responsibility.

Mr. DAVIS. Now, Mr. Raines, for the relationship to work shouldn't there be some arm's length between OFHEO and Fannie Mae?

Mr. RAINES. Yes, I believe we should run the company and they should examine the company.

Mr. DAVIS. Is that relationship or that desirable relationship undermine if OFHEO somehow becomes an advocate and if they appear to have developed their own agenda with respect to the future of Fannie Mae?

Mr. RAINES. Well, I think it does raise serious questions of who is ultimately responsible for the outcomes. I mean, if we are doing what they say then who is to be held accountable for what happens?

Mr. DAVIS. Okay. Let me ask you one final set of questions because our time is so limited. The ultimate mission of OFHEO is to preserve the safety and soundness, correct?

Are either of you concerned that by issuing a public condemnation of Fannie Mae and its practices, a public condemnation of the management structure, a public condemnation of its accounting in advance of the SEC doing it, are either of you concerned that that could somehow jeopardize Fannie Mae's status in the market and that that could, in its own right, have an impact on safety and soundness?

Mr. HOWARD. I am very concerned about that.

Mr. DAVIS. Could you elaborate on that, Mr. Howard, for a minute?

Mr. HOWARD. Certainly. The markets respond to—as Mr. Raines mentioned earlier, regulators have enormous power and they are perceived by investors, particularly international investors, to have such power. And most regulators do not make pronouncements of the nature that we saw over the last two weeks without very serious convictions that those are true.

Mr. DAVIS. One final question, if the chair will indulge me just a few extra seconds, one of the things that we have heard about is the fact that OFHEO went to the board of directors and essentially put a 48-hour ultimatum in place.

Do you know of any authority that OFHEO has to give an ultimatum to the board of directors with its course of action? Is there any statutory authority for that?

Mr. RAINES. I don't know of any such authority, no.

Mr. DAVIS. And to your knowledge, did OFHEO give any explanation of why it was so time sensitive that the board of directors move forward?

Mr. RAINES. I believe what they said to the board was that they thought the matters were serious and they wanted to test the seriousness of the board in responding to the report.

Mr. DAVIS. Is it within OFHEO's charter to test the seriousness of the board of Fannie Mae? Is that written anywhere in their charter of their job description? That sounds like a fairly political purpose, doesn't it? Or a little bit of an agenda based purpose; we want to test the seriousness of the board.

Chairman BAKER. If you can, make that your last question because we do have others and we have another panel too.

Please respond if you choose.

Mr. RAINES. No, I am unaware of any specific statutory reference to that.

Chairman BAKER. The gentleman's time is expired.

Mr. Castle?

Mr. CASTLE. Mr. Chairman, thank you very much.

I don't want to get into this, it is funny how you think you are going to ask one line of questions and then you hear something else and you immediately want to follow up on that.

I don't necessarily agree with Mr. Davis, for whom I have tremendous respect I might add, on—or even the answers to some of that. I mean, it seems to me OFHEO has a real role in all of this and to me, I mean, I agree with you, Mr. Raines, in sort of the role of examining.

But I think when they examine and there is something that with which they don't agree I think they have some responsibility actually to make it public. I think you would agree with that. In fact, it shows in your testimony, your very good testimony, here today.

I mean I am one of those who worries about Fannie Mae. I think, you know, you have good people running it and that kind of thing, but, frankly, it is very large, some of the practices I think are a little marginal. I worry about this perception the Congress will back up whatever Fannie Mae does. I just think there are a lot of issues.

I think the regulatory issue is very important though. And somehow or another we have lighted a fire under OFHEO who I would have written off a year ago and all the sudden they got a tiger by the tail type thing. I don't know what is right or what is wrong. But, I just want to make sure that Fannie Mae is being run correctly because it is very, very important. And I worry about the safety and soundness of that.

But, on the other hand, hey look, we are all running for office right now. We are criticized daily by our opponents. So a little criticism can't be the end of the world. And perhaps if it is justifiable criticism and changes are made, perhaps that is positive. I look at your testimony——

Mr. RAINES. Congressman, if you are being accused of committing a crime it is a little bit different.

Mr. CASTLE. Well, right. But, you know, I am not—the jury is out on all of this right now. But the whole point is that some review I think is essential.

For example, if you look at page two of your testimony you have made several changes as a result of what OFHEO has done, at least as I understand it. You go through the first, second or third

and I don't need you to go through all the details, but you go through all the things that you have done, the building up the 30 percent capital surplus, the chief risk officer, et cetera, et cetera, some probably more important than others. And I couldn't begin to tell you, which you probably could.

But these are changes which you have pretty well agreed to, perhaps not totally willingly, but you have looked at it and you have made the decision that these are things you probably should do that would benefit you that you did not do of your own accord but you did because of the OFHEO—because OFHEO was involved or is that correct?

Mr. RAINES. Congressman, we don't look for things to disagree with OFHEO.

Mr. CASTLE. Right.

Mr. RAINES. Many of these things we would have been willing to do if OFHEO had approached us in a different way. So this isn't an issue of everything OFHEO says is wrong and everything we say is right.

Indeed, I think the fundamental flaw, if I could say what the fundamental flaw is in our relationship with OFHEO, it is not created by OFHEO. It is created by the fact that the OFHEO examination process does not have the same legal protection that the bank examination process has. And that has a negative effect on the entire relationship.

Bank examiners are not allowed to make public bank examinations, even if they are requested by a member of Congress.

Mr. CASTLE. I want to go to another line of questioning. I am not going to parse that or argue it too much, except to say that I think there are certain powers that OFHEO, perhaps, should have that they don't have and perhaps there are others that they have that they should not have.

I just think I want to get it straightened out. I mean, my sense is that you all have been sort of back and forth on whether there should be a successor to OFHEO or not. I hope that somehow or another when this is all said and done we can get this whole oversight, overview, examination, regulatory aspect of it correct.

Mr. RAINES. I agree.

Mr. CASTLE. Because I just think that is important for all of us. That is my goal and I hope we can get great cooperation on that.

Let me go on to this whole business of 98 because I don't totally understand it. But my understanding is when all this happened you were CEO, is that correct? Mr. Johnson moved on and you were CEO?

Mr. RAINES. I became CEO at the beginning of 1999.

Mr. CASTLE. 1999. So this happened at the end of 1998?

Mr. RAINES. No, it would have happened in 1999. The books are closed in January. So I would have been CEO.

Mr. CASTLE. Okay. Well, with respect to—this change really bothers me and I don't know if this is something that has been stated. There is no proof of it and I don't know whether it is correct or not, so this may even be hypothetical rather than practical. But, it concerns me that if, according to the report, and dug it out, and it was filed by OFHEO.

I am sorry, according to the testimony, which we had today by Mr. Falcon it basically states that the amortization models of management were $400 million, however management decided to record only $200 million that year and then spread the rest over the next year, which allowed bonuses to be paid.

My question is, is there any record of that or is that just something that happened? Did they look at minutes of meetings or e-mails or anything to make that determination?

I mean, that, frankly, does have overtones to it that we can speculate on how serious they might be. But I think we all would agree it would be pretty serious if, indeed, a decision was made to put extra—to violate a standard accounting procedure and to put extra money into a different year to resolve the—or to lessen the——

Mr. RAINES. It is a very serious——

Mr. CASTLE.——keep the gains high the year before.

Mr. RAINES. It is a very serious allegation. The report states no facts. It doesn't cite one piece of paper. It doesn't cite one witness who says that that decision was tied to compensation.

As I mentioned earlier, we actually launched an effort, once we heard this allegation, we launched an effort to go and look at the facts. And if you look at the facts as to how this occurred we have found no facts that indicate that this decision was tied to compensation.

Mr. CASTLE. Did you find any facts—I know my time is almost up and I have 15 second I have to yield to Mr. Shays. But did you find any facts that would indicate the decision is in violation of standard accounting procedures? That is what they are stating. That is a pretty serious allegation.

Mr. RAINES. No. We didn't find any of those facts either. Our auditors looked at the decision at the time.

Mr. CASTLE. Right.

Mr. RAINES. And they approved the financial statements and they reported to the audit committee that there were not estimates that they believed were unreasonable.

Mr. CASTLE. But KPMG apparently found an audit difference on this, as I understand it, a term which KPMG, this according to his testimony again, disagreed with Fannie Mae.

Mr. RAINES. There was an audit difference. This is what is called a subjective difference, which means that there are different ways to do it, but when it came to the board, and the board—and they would have to report to the board, were there any estimates by management that they felt were unreasonable, their answer was no.

Mr. CASTLE. So the decision was made, there was an adjustment made and then the question becomes is what was the behind that decision and whether or not it met good accounting practices or good corporate practices.

Mr. RAINES. And we looked at the contemporaneous records and you can see in the contemporaneous records, in fact, that the calculations that OFHEO is relying on were not possible because no one knew what the EPS number was on the date that this decisions appears to have been made. So this false precision of just getting there exactly was impossible to know because the books hadn't been completely closed for several more days.

So that is what I am saying. We have looked at the facts. There appeared not to be any facts to back this up. And if OFHEO has facts that back up, you know, we would be delighted to see them.

Chairman BAKER. The gentleman's time has expired.

Mr. CASTLE. I was supposed to give 15 seconds to Mr. Shays.

Chairman BAKER. Well, let me suggest this, I had one more question and I had not had an opportunity to speak to Mr. Howard, if everybody wants to take 2 minutes, let us constrain.

Mr. SHAYS. I wonder if I could go now because I have a——

Chairman BAKER. We would be happy if you would leave now.

Mr. SHAYS. Would the gentleman yield?

Chairman BAKER. I am sorry, you want to say something first, I didn't understand your request. Yes, I would recognize the gentleman.

Mr. SHAYS. Thank you.

I just want to put on the record, Mr. Raines, that in communicating after your comment about the subpoenas to the office of compliance, they said they had requested thousands of documents and some of these documents simply were not coming. They got concerned about it. They particularly wanted e-mails. And only after they provided a subpoena request did the e-mails start flowing.

And in conversation with Justice they basically said Justice said it wasn't necessary because now the e-mails were flowing, which is not uncommon in Congress when we issue a subpoena. Sometimes the threat of the subpoena provides that information from flowing.

And I just want to also say that the reason why this information is public and you don't want it to be public now is they felt this was so serious that this information shouldn't be suppressed. And I happen to agree with them on that account as well.

Mr. RAINES. Well, if I might.

Mr. SHAYS. I thank the gentleman for yielding.

Mr. RAINES. If I might?

Mr. SHAYS. Sure.

Mr. RAINES. Fist of all, what I gave you was what the contemporaneous statement was, not what is being said today, but what was said at the time the subpoenas were issued.

Mr. SHAYS. Right. They didn't need it because you were now complying.

Mr. RAINES. No, at the time the subpoenas were issued, not the time they went to the Justice Department, the time the subpoenas were issued, they told us they were not doing it because we were not cooperating. So, that, I think, is a very important distinction.

Mr. SHAYS. They are saying that they were no longer necessary because after the subpoenas were provided that there started to be more information flowing, that is——

Mr. RAINES. That is a Justice Department issue. That is not why they issued the subpoena in the first place. That is where——

Mr. SHAYS. So there is a disagreement that we are going to have to nail down.

Mr. RAINES. Yes.

Mr. SHAYS. You have your opinion, they have their opinion.

Mr. RAINES. I think that is exactly right. But the second issue on why this was made public, the exact same kind of examinations

go on with big banks, small banks, thrifts, without special examinations being published. So there are other ways to do this. This is an anomaly. OFHEO is the only financial regulator who does not have the——

Mr. SHAYS. You are under the 1934 act.

Mr. RAINES. I am sorry?

Mr. SHAYS. You are under the 1934 act, public disclosure.

Mr. RAINES. No, their examination has nothing to do with the 34 act. It is solely to do with the banking laws. Under the banking laws, examinations are secret. And that helps the relationship between examiners and the bank because they can have very free flowing discussions. OFHEO doesn't have that. It is not their fault. They have very good examiners. We are not quibbling with that.

But the process is not a good process. We think the process that exists between examiners and the examinee is best referenced to looking at how the OCC has that work. And that is what we strive for. We are going to work with OFHEO to see if we can get there. But they do have this one disability that is not their fault, which is their examinations are going to be made public and that has a negative effect.

Mr. SHAYS. What I would like you to do, though, is work with Congress to get a stronger enforcement process. That is what I would like.

Chairman BAKER. Your time is expired, Mr. Shays.

Mr. Kanjorski, did you have a follow-up?

Mr. KANJORSKI. You know, a part of what we have to ultimately do is come up with a new regulatory scheme here. And I have been listening to this testimony and I was thinking since we have a regulator for two entities, you know, why can't we make an in-resident meat inspector, if you will, that is down at your place 24 hours a day or however necessary.

But when you have these exit strategies where something like an audit difference comes up, wouldn't it be more likely to end up without disputes or problems if the regulator sat in and knew what the issue was on the rulings so that they don't miss it?

Mr. RAINES. Congressman, we actually have 40 OFHEO examiners resident at Fannie Mae. And so we do have them in close proximity. And we do believe that our examiners are aware of the closing process and of the findings of our auditor. That has never been hidden from our examiners.

Our normal examining process, I believe, has worked well. Our only difference is how the special examination has worked. It is not about the normal examination process.

Mr. KANJORSKI. But why didn't somebody in the normal examination process be sitting in, to know what this audit difference was in 1990?

Mr. RAINES. My personal belief is—and I will go check—my personal belief is that our examiners were aware of this.

Mr. KANJORSKI. Well, you ought to examine your records and get the worksheets and see whether—somebody should have been there, to know that that was discussed, that the issue was resolved in one way or another and obviously acceptable to the regulator.

Mr. RAINES. And I will come back to you. I will check on that. But my belief is that our examiners had been well informed, and

they have been very professional people. They have been aware of each and every one of these accounting decisions over the years, and they have exercised their judgment on them in that process.

So, we are not—we have no complaints about the normal examination process. We believe it has functioned. And they have hired people who examined other large financial institutions. They now have a new examiner in charge, who I just met with, and he has met with our senior management. And we are going to work with him to make sure we have the best possible examination relationship that exists.

Chairman BAKER. Mr. Castle, did you wish another 2 minutes?

Mr. CASTLE. I just have one comment, if I may, Mr. Raines. I heard you say earlier, based on this level—the executive officer compensation chart—that it is the road path, that people will come and steal your employees.

I have seen the salaries. You don't have to worry about Congress coming up and stealing any of your employees.

[Laughter.]

Mr. RAINES. Having been a federal employee a couple of times——

Mr. CASTLE. You know the problem.

Mr. RAINES. I know the problem. I know it well.

Chairman BAKER. Ms. Waters?

Ms. WATERS. SEC has been referenced any number of times here today. And I guess Mr. Falcon said that there were overlapping responsibilities.

What is SEC doing now? Have you been examined by SEC in the past, since 1998? What have they said about your accounting practices? What part of this have they overseen, examined, investigated since 1998, and what are they saying now?

Mr. RAINES. Well, the SEC has been enormously cooperative with us in our process of becoming a registrant. We are the largest business ever to become a new registrant with the SEC. They have never had an $800 or $900 billion entity do that.

They were very helpful in that process, in reviewing our initial documents and giving us feedback. So, they have bent over backwards to be helpful. I am enormously grateful to them for that.

They have also worked with us on sticky accounting issues. And we, like other companies, have presented accounting issues to them and asked them for a judgment as to what the appropriate accounting is and, again, they have been very responsive in giving us answers.

We, of course, have implemented the answers that they have given to us. So, we expect that the SEC will carry out their function here. They are busy; they have a lot of things to do. I don't know what their timetable may be——

Ms. WATERS. Have they been in touch with you since this information became public?

Mr. RAINES. We have had contacts through counsel with the SEC Enforcement Division. But also we have had contact not through counsel—through business people—and with other parts of the SEC. So we try to maintain good communications with them.

It is my desire now—as it would have been my desire before the report came out—that these accounting issues simply go to the

body who can solve them. Then we will have the answer. We won't be having a debate about who is right and who is wrong.

There will be an answer and we will implement it and go forward.

Chairman BAKER. Gentlelady's time has expired. I only had one further request of you, Mr. Howard. In order to better understand your explanation and your responsibility with regards to the $200 million expensing issue of 1998, I would like to request a written response, which I will submit to you at a subsequent time.

The reason for asking the question in the hearing is that if your response would be pursuant to your oath taken during the course of the hearing, which would establish some important value to your written response.

The essence of the request will go to the manner in which the expense amount was determined, why the figure was arrived at, the chronology of that decision-making process, those who participated, if it did not rise to your level.

As you represented earlier in the hearing today, there are some financial decisions that come before you, some that do not. We need to know if it did not, to what level did it rise? Was this matter discussed among all executives? Did it go before the board for at least an announcement or some disclosure to the board?

Basically, a process by which we can be sure, as members of the committee, we have gotten complete and full explanations as to the elements that OFHEO has brought to our attention.

Please understand, in my capacity, I am presented with a very contentious and volatile report. If I were to have left Washington D.C. and gone home without addressing the elements of this report, I can only imagine the criticisms that would be leveled against this committee for its inaction.

Should the interim report plead OFHEO to take the next step and issue some other yet unknown criticism, it certainly would leave this Congress in a very untenable position as the entity responsible not only for the creation of OFHEO but for creation of Fannie itself.

I certainly hope that the future does not bring ill-advised consequences to the institution, its ability to extend credit to prospective homeowners or, even worse, to have consequences for taxpayers.

My role is to examine, thoroughly examine, and I hope to spring to speedy resolution all of these matters. I have no interest in, nor motivation, to bring any adverse consequence to the enterprise or to Freddie Mac and, I will continue, however, to be the arm's length examiner of enterprise conduct that we appear, in your view, not to have with OFHEO.

With that disclosure and no further comment, thank you. And this panel is dismissed.

If our witness for our third panel is able to make it to the desk, we would invite her to do so now.

Thank you very much for your participation.

Welcome the presiding director of the board of directors of Fannie Mae, the honorable Ann McLaughlin Korologos. Is that correct?

Ms. KOROLOGOS. That is right, sir.

Chairman BAKER. It was previously determined by mutual discussion that all those who would testify before the committee in this proceeding would be asked to take the oath. Do you have any objection to being sworn in?

Ms. KOROLOGOS. I do not.

Chairman BAKER. If you would not, do you seek the advice of counsel during your testimony?

Ms. KOROLOGOS. I do not.

Chairman BAKER. If you would not mind rising and raising your right hand, I will administer the oath.

(WITNESS SWORN)

Thank you very much. Please be seated. Consider yourself sworn in and under oath.

As we have extended to all other witnesses in the course of the morning and afternoon, we request that the presentation, if possible, be limited to 5 minutes. Given the gravity of the issue before the committee, however, we would certainly extend any courtesy to you to proceed at your discretion.

Your official testimony will be made part of the record. Please proceed.

STATEMENT OF HON. ANN MCLAUGHLIN KOROLOGOS, PRESIDING DIRECTOR, BOARD OF DIRECTORS, FANNIE MAE

Ms. KOROLOGOS. Thank you, Mr. Chairman, and I hope I can keep more or less to the 5 minutes. I know it has been a long day, but I appreciate the opportunity to be here.

I would like to thank Chairman Oxley, Ranking Member Frank, Chairman Baker, of course Ranking Member Kanjorski and members of the Subcommittee.

My name is Ann Korologos and I am the presiding director of Fannie Mae's board of directors. I also currently serve as chair of the Nominating and Corporate Governance Committee and on the board's Compensation Committee.

I am a shareholder-elected, independent director. I have served in three Cabinet departments, including as secretary of labor under President Ronald Reagan, and I headed the Presidential Commission on Aviation Security and Terrorism, specifically investigating the bombing of Pan American Airways flight number 103.

The board of Fannie Mae appreciates this committee's oversight of the company, of the board and of our regulator. And I welcome the opportunity to speak on behalf of the board about OFHEO's report to date on its special examination.

The board takes the issues raised by the OFHEO report very seriously. We are here to do the right thing. By that I mean: to OFHEO, the SEC and Congress, and to do so in a way that protects the shareholders and restores the public's confidence.

In this way, the company can continue to fulfill its critical housing mission: to use the financial flexibility of a private company to pursue the societal goals of increased homeownership.

As directors, we must meet our fiduciary duties of loyalty, care and good faith. We do not take these responsibilities lightly. These duties have meaning. They require us to gather the facts, conduct an objective investigation and render judgment based on the facts.

We must look at the issues in the report deeply, thoughtfully and carefully, using whatever resources are necessary. And we will be held accountable for how we meet our responsibility.

The board, with independent counsel and independent accountant, will investigate the issues in the report, and we will work expeditiously. So I thank you for this opportunity to speak on behalf of the board. We were moving fast before this hearing, and I can share with you that we now are continuing to do so, and we now know where we are going.

The board has participated through our audit committee, in following the company's response to the examination since it began over a year ago. We have received regular reports from the audit committee on the examination's progress, as best it could be understood.

On Friday afternoon, September 17, Director Falcon contacted me to say that OFHEO wished to share its findings to date with the outside directors of the board. I convened a meeting of the board for the next business day, which was Monday, September 20.

Every nonmanagement director attended in person or by telephone. On that day, we received the written report and OFHEO's senior staff made a presentation to the nonmanagement directors and the company's outside counsel.

The staff also gave us a letter from the director and a draft agreement, to be signed within 2 days, outlining actions to be taken. In addition, the board was informed by management, after that meeting, that they had received a call from the SEC that these issues would be a part of an informal inquiry by that regulator.

The board immediately began a series of meetings and discussions with OFHEO over the week of September 20. I think I either spoke or met with Director Falcon every day that week. I assured Director Falcon that the board and the company would work cooperatively with OFHEO and that we would address all their concerns.

I also expressed the boards hope that our work together would build a constructive relationship based on mutual respect and trust going forward. I told him, however, that the board could not, consistent with its fiduciary responsibilities, sign a document in 48 hours.

On Tuesday, September 21, I advised the director that the board had authorized the hiring of independent counsel, former Senator Warren Rudman, and his law firm, Paul, Weiss, Rifkind, Wharton & Garrison LLP, subject to OFHEO approval, to address the questions raised by the OFHEO report.

I also advised the director that we would provide to him, the next day, a draft work plan based on the actions required by OFHEO's agreement. On Wednesday, Pat Swygert, a fellow board member and President of Howard University, and I met with the director and his senior staff at OFHEO offices.

We provided the draft work plan that was approved by the board and, because so much of the report had been leaked to the press by that time, I also advised the director that the company did not object to OFHEO's public release of the report.

After reviewing the draft work plan, Director Falcon told me later that evening that he thought the plan was substantive and

addressed each of the areas of concern raised by the report. I have attached to my written statement a copy of this draft work plan.

On Thursday, in a conversation with OFHEO's general counsel, however, it became clear that OFHEO wanted a written agreement to be signed by the board.

Therefore, at my direction, on behalf of the board the company's counsel began meeting with OFHEO staff to reach such an agreement. Discussion continued throughout the weekend, and after additional board meetings, we and OFHEO announced the September 27 agreement.

With the agreement completed, the thorough process to address OFHEO's report is underway. Importantly, management has pledged its cooperation to the board in effort and we will hold them accountable to that pledge.

The details of the agreement are well known. The company will move immediately to begin making a number of changes including a capital surplus plan, accounting policy modifications, internal control enhancements and other changes.

The board's independent counsel, Senator Warren Rudman and his law firm were approved by OFHEO yesterday. Senator Rudman will hire independent accountants, also subject to OFHEO approval.

Senator Rudman's work will also be reported to the SEC. We expect Senator Rudman to conduct his review as described in our agreement with OFHEO and to report his findings to the board, OFHEO, and the SEC

The company and its outside auditors have a disagreement with OFHEO about some aspects of the implementation of FAS 91 and FAS 133. The agreement establishes a process going forward to resolve these issues.

This board believes in accountability and objectivity. We will not prejudge the outcome of this process, and I respectfully ask you not to prejudge it, as well. We vigorously share your concerns and want to get to the bottom of this.

We believe that we have built a sturdy, corporate governance structure to be prepared for any challenge this organization may face. How this board and the company handle themselves when things go wrong is the ultimate character test.

We have benchmarked our governance against other companies. Our nonmanagement directors meet as a group, without management, every time the full board meets, and often in between. These are candid, probing discussions.

Our standards for director independence more than meet those of the New York Stock Exchange. Mr. Chairman, I would be remiss not to comment on the article which questions the board's independence in today's paper.

Two years ago, we applied the New York Stock Exchange standards for director independence enhanced for our board's accountability. We worked with our outside governance counsel, Gibson, Dunn & Crutcher.

We developed a director questionnaire and a process for matching directors' nonprofit and business connections with corporate or foundation contributions or business relationships.

For example, for a business relationship, a director is considered not independent under these guidelines. We take a five-year look back versus a three-year look back under the New York Stock Exchange rules.

On an annual basis, an excess 2 percent of consolidated gross revenues or $1 million, whichever is greater, would determine independence. And for charitable organizations on an annual basis, a $100,000 or 5 percent of gross revenues of the charity or the non for profit, whichever is less.

The New York Stock Exchange permits charitable contributions of any size and only requires disclosure of donations in excess of $1 million or 2 percent of the director's charities gross revenues.

In addition, no direct compensation other than director pay is permitted under our guidelines although the New York Stock Exchange permits directors to receive up to $100,000 per year in other pay before they are no longer independent.

In addition, one director has a personal business relationship issue, and that was brought to our attention some months ago, and a decision on independence will be made at our October Governance Committee meeting.

We have, therefore, regardless of reports in the press, I think, applied both the spirit and the fact of the criteria for independence and that that is put forth in the New York Stock Exchange guidelines.

If the New York Stock Exchange, governance watchdogs or anyone else wants to change those guidelines, you can be assured that we would change ours and meet those requirements. I thought I might offer to submit, for the record, the board guidelines so that you would have them with this testimony.

If I may speak personally for a moment, I have known some of you over the years from my experiences in both public service and the private sector. And I think you know my commitment to ensuring that our laws are upheld and the institutions of our economy maintain the highest levels of integrity.

There is only one way I know how to deal with such a difficult situation: to speak the truth, to find the facts without bias, to base judgments on those facts, and then to act without hesitation. We must do the right think carefully and deliberately. We must not rush to judgment or take actions in haste today that we will have to correct tomorrow.

I will commit to you that the board is determined to follow a process that will inspire confidence and restore public trust.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Ann McLaughlin Korologos can be found on page 171 in the appendix.]

Chairman BAKER. Thank you very much for your statement. Let me quickly say that I have no question either about your service as a board member nor any of the independent board members.

Ms. KOROLOGOS. Thank you, Senator.

Chairman BAKER. I do think, as you have stated, today's problems present a challenge that will require decisive action based on full knowledge and confirmation of all the facts.

What is problematic in the current environment is that, as Mr. Raines was before the committee for some time this afternoon, on

a number of occasions in response to various questions, he would state the report cites no facts, speaking to OFHEO's report.

I find that troublesome with regard to coming to an agreement that is in everyone's best interest. I will be the first to say that no report is probably 100 percent accurate. But I would also quickly observe that few reports are 100 percent incorrect.

I note that the board took rather quick and decisive action in reaching this first agreement, which would seem to indicate to me that there were some reasons the board came to a conclusion that it was appropriate to enter into that agreement.

Do you believe that OFHEO is a competent regulator?

Ms. KOROLOGOS. I don't know that I am equipped to make that judgment. I had the opportunity to meet with the director about 8 months ago as chairman of the governance committee, which turned out to be fortuitous. So, when I received the call, I knew the director.

Generally speaking, boards don't involve themselves in this detail with the regulator, frankly, at least not in the companies I am involved in. More so, in financial, I can't make that judgment.

Chairman BAKER. Okay. Do you believe, knowing what you know now from the substance of the report made available to you, that the board has been advised sufficiently, frequently enough, and to sufficient detail to have made appropriate judgment in the matters of concern in the OFHEO report?

Ms. KOROLOGOS. Do you mean with regard to the agreement or generally speaking——

Chairman BAKER. Generally speaking in your capacity as an individual board member, do you feel you have been given sufficient information about the business judgments made by management of the corporation today?

Ms. KOROLOGOS. I would say that the report raises issues that clearly are serious. That is why, again, with OFHEO's encouragement, through their agreement, we have retained independent investigators, both on the accounting side and, as you know, for some of these other issues.

So I don't want to prejudge anything by answering your question.

Chairman BAKER. And, my next question is not to lead you to a statement that would be interpreted incorrectly.

I have read accounts from various independent board members at different times making the statement that they have full confidence in the judgments made by, and fully support the current management. As you outlined, going forward, we need to know all the facts, follow all of those facts to their end conclusion.

As you encouraged the committee and others not to jump to any presumptions before that process is finished, I would hold that door open both ways; that we not rise to the defense of all parties until we have come to a judgment as to everyone's involvement, if there is found to be a substantive accounting problem that was inconsistent with GAAP that led either to shareholder value being depleted or reports to the markets of incorrect financials.

I think it was clear from the testimony of Mr. Howard and Mr. Raines. They first don't see a factual basis for the allegations that have been made by OFHEO but, secondly, can't make full judgment about the accusations until they have more information.

Is it your view that the board, going forward, will reserve judgment in all these matters whether it be positive or negative?

Ms. KOROLOGOS. I think so, completely. I will say that they have in the past and, if I might comment—since I am one of the people who were quoted in the press—I think this is a good forum to develop that because I wholeheartedly agree with you. My statement asked that none of us prejudge, of course, and we should be objective, and this board can be objective and is objective.

When I called Frank Raines, the Chairman of the company, to tell him I had received a call at 4 o'clock on Friday from the director, his first response when I said I would convene a meeting was, "How can I help?" That is a first-class CEO.

Consistently, over these weeks, management has asked, "How can we help?" That is the spirit of cooperation that we have with management in order to achieve all that we want to achieve. That does not detract from our objectivity.

Many of us on the board have been there long enough to have worked with management over many issues on a great company achieving its mission. So, in that spirit, yes, certainly, we have experiences.

I don't think that is mutually exclusive from the job that we have laid out, and I commit to you our objectivity, our unbiased tenacity to go forward and find out, if you will, the other side of this report and see where it comes out.

Chairman BAKER. Well at least an exploration of all the allegations OFHEO makes should be thoroughly vetted and conclusions reached. I hope that the findings are not as severe as OFHEO has represented them to be, but we all have a duty to find out.

Ms. KOROLOGOS. Absolutely.

Chairman BAKER. And I thank you for that.

Mr. Kanjorski?

Mr. KANJORSKI. Madam Secretary, am I correct that you have been on the board at Fannie Mae for 14 years?

Ms. KOROLOGOS. Oh, you are making me older than I am.

Mr. KANJORSKI. Eleven years.

Ms. KOROLOGOS. Ten years; just 11 this year, so 10 and a half.

Mr. KANJORSKI. So you predate Mr. Raines tenure.

Ms. KOROLOGOS. I do, sir.

Mr. KANJORSKI. And you predate one of the issues that we have had the regulator testify about today, the FASB 91 audit difference that was reported in 1998. First of all, I would like to test your memory.

Do you have any recollection at any time of your auditors, management or the regulator talking to you or other members of the board about this handling of the $400 million or $200 million in 1998 that has been the object of one of the charges made by the regulator?

Ms. KOROLOGOS. I don't have a recollection. I presume it would come through an Audit Committee report, and I can't promise you that something was said but I don't remember anything being said; no.

Mr. KANJORSKI. I know very little about how regulators operate and even less about how many analysts they have at your agency.

Mr. Raines tells me they have 40 in-house meat inspectors. Pretty broad exposure.

Do you, in the last several weeks, in meeting with the auditor and getting their report and meeting among the board with your various experts that you have retained now, do you have a sense as to whether or not there is a systemic risk problem at Fannie Mae?

Ms. KOROLOGOS. I do not believe there is a systemic risk problem at Fannie Mae nor have I been in any gatherings that would lead me to believe that. I certainly would not have signed on behalf of the company, the agreement, if I didn't take into consideration the impact of the agreement, as well, and also the capital plan that is being developed and the likes.

So, no, I don't. I haven't heard that and I don't feel that.

Mr. KANJORSKI. Very good. One of the things that amazes me is the regulator, in testimony earlier today, indicated, of course, that OFHEO has been auditing or regulating since 1991. And it is in 1998, one of the audits obviously had a finding that was an audit difference as to how to handle this particular transaction.

I was just struck why they didn't pick that problem up in 1998 or 1999 or any subsequent year that they had to deal with that audit report; that is, that the regulator didn't pick it up. It seems to me almost the first area that you would begin to do your regulation, is to look at the outside audit report.

Has that struck you at all as being peculiar?

Ms. KOROLOGOS. I have to say I only learned that from these hearings today. It strikes me the way it strikes you, sir. I would think that would be certainly a first stop; maybe not the last stop, but a first stop for a regulator.

Mr. KANJORSKI. One of the things that we have been struggling with over the last year and a half is to create an independent, world-class regulator for Freddie and Fannie. We thought we were going to come close to success not too long ago but, for reasons that are in the atmosphere in Washington, that didn't occur.

But, invariably, as a result of this investigation and the Freddie Mac investigation and the testimony we received from the regulator this morning, I am absolutely thoroughly convinced that we have to do something to create a stronger, more independent, world-class regulator; other than that, Mr. Baker and myself are going to be remiss in carrying out our responsibility.

But in starting that process, I am just at a loss as to how something could happen in 1998 and be listed as a finding in an audit report, and the regulator didn't ask anybody about it or get any information about it or resolve the application of GAAP rules to that particular finding.

It just blows my mind, and $200 or $400 million is a significant amount of money, even in a huge institution like Fannie Mae.

So, I am not sure that this was a wasted hearing from any standpoint, because we heard, for the first time, really, that process that the regulator has gone through. And I am not casting aspersion to this point on Mr. Falcon because he was not there, as I understand it, in 1998. He came subsequently.

But, apparently, we have done one poor job as federal regulators, particularly of these two institutions. If nothing else, we should get

that straightened out. There has been a lot of press, a lot of it bad, and as all of us know, it had some impact on the stock of Fannie Mae.

Do you feel there is any reason, in your role on the board, that going forth from this hearing, both the investing public and the purchasers of your obligations should have any fear at all as to the security and the position of Fannie Mae, that their investments are secure?

Ms. KOROLOGOS. I don't feel so. I feel that the agreement that we signed puts us on a very acceptable path to giving strength and clarity and openness to the issues that have been raised. I think that should be, I hope, assuring to the public. That is part of what I think our responsibility is; to the public—all the public, employees, investors, shareholders, the like.

Mr. KANJORSKI. Well, my sense of you—I should disclose for the record, we had the occasion to meet yesterday—I can't remember ever being more impressed even though we do differ politically. But with your basic competency and capacity, you certainly have won my faith that you are going to do a job and how you have gone about it really impresses me.

I want to join my colleague, Mr. Baker. This is not the happiest role we have to play, as members of Congress. But quite frankly, the testimony of yourself today and the CEO, Mr. Raines, and Mr. Howard, the CFO, and even the regulator gave me a little bit more confidence that we are not dealing with something that is dangerous here to the public or is terribly disastrous to Fannie Mae.

But it is good that we get it over with and if you keep the captain of that ship, you are going to let me sleep a lot better. Thank you.

Ms. KOROLOGOS. Thank you, sir.

Chairman BAKER. The gentleman yields back.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman. I wanted to go back to a line of questioning I started with Mr. Raines, which I think gets to the fundamental problem that has been brought before this committee, and that is that your board made the decision to tie the compensation bonuses to earnings per share.

Can you comment on that? I think it is very important that I reaffirm Mr. Raines's comment that this preceded him because I think there are several things that I am very concerned about. One is the credibility of Mr. Raines, who runs that department, which means the credibility of Fannie Mae.

This serves a very, very important constituency for all of us across the country who are concerned about making sure we have adequate housing, affordable housing for all income levels.

But I would like to find out why that board felt it believed that it was appropriate to link executive compensation to earnings per share, and whether or not this move, this compensation scheme, resulted in inappropriate incentives for management?

I think that unless we can clear that and try to get some common ground on that issue, especially as I mentioned, with the chart that Mr. Baker has provided this committee—which I am sure we are not the only ones who are going to see that chart—it is going

to show some stark comparisons between what actual salary was and what those bonuses were.

So, there is certainly meat for incentives here. I think this might be something we want to share. Could you give me your comments on why this, you felt, was appropriate?

Ms. KOROLOGOS. I would be happy to. Again, I have only been on the board since 1994 but, in both my experience at Fannie Mae and many other corporate boards—in some case, where I am also on comp committees—earnings per share was a very acceptable incentive, if you will.

Generally combined with others, different companies did it different ways. So you are not talking about a company that was the only one. I wanted to make that clear.

Why was that? Well, in the late 1980s, early 1990s, the acceptable philosophy for compensation besides always, in some way being performance based, was to tie management to the shareholder, and earnings per share was one way to do that. Likewise, options, which we saw become out of favor and the like. In a way, I would think we would all take comfort.

At Fannie Mae, it is a much more, even transparent process than at other companies precisely because we are a GSE. Unlike other public companies, the amount our executives make is somewhat dictated by law, and the law states that OFHEO is required to ensure that Fannie Mae's compensation programs are reasonable and comparable with compensation for employment in similar industries.

We use the comparability test of looking at peer companies and the like and structuring not only the earnings-per-share measurement, but in other aspects as well, both tangible and intangible performance measures and the like.

So you generally have salary, you have bonus, you have long term, you have short term kind of incentives. So you try and strike a balance between financial and nonfinancial measures.

Earnings per share, for purposes of this report, seem to have jumped out and your question is quite a legitimate one. I would only say that it is becoming, in recent years because of incentives leading, in some companies, to behavior that wasn't intended to relook at compensation. And there are a lot of different mixes going on.

Mr. SCOTT. You have seen the report that was presented before the committee——

Ms. KOROLOGOS. I actually did not see the paper that was handed out yet. No, I have not.

Mr. SCOTT. But you are familiar with the bonus and the structure and the comparison of base——

Ms. KOROLOGOS. Yes, very much so.

Mr. SCOTT. Do you stand by that? Do you feel that——

Ms. KOROLOGOS. I stand by what we did; yes, I certainly do, and I think that I have found, again, my experience on a number of other boards; it is always a work in progress. We use outside consultants as well, is what I wanted to assure you.

So this is not something we plucked out of the air and allowed to hang out there to be abused in any way, shape or form.

Mr. SCOTT. Well I think this is very important to get on the record because, as I said earlier, there have been some very strong accusations made against Fannie Mae, and I want to make sure you have a chance to respond to that.

If I may continue, in view of that, what changes, if any, in corporate governance and some of these compensation policies that the board is considering to address in relationship to the issues that have been raised by this report and, again, I too question the timing of it and I think there probably are some motivations there.

People say politics isn't a part in that, but you really can't take politics out of politics. I believe really, as a result of today's hearings, that politics has certainly manifested in what we have here.

But, having said all of that, OFHEO has given a report. Are you going to make any changes in the way you operate and, if so, in governance and in compensation, as a result of this board and some of the issues that it has pointed out?

It runs the gamut of misapplied accounting rules, has kind of stabilized the earnings, the inadequacy of the regulatory capital, the deferred expenses. It just seems to me, do you take this report, just say there is nothing here, or do you take it and say here is what we are going to do to try to fix this situation.

Do you give this report credibility?

Chairman BAKER. And, Mr. Scott, that will have to be your last question because you are well over time.

Ms. KOROLOGOS. Let me assure you, I think—two significant things, perhaps. One, the agreement we signed itself permits us—I think there are 32 or 33 issues there—working with Senator Warren Rudman and the accounting people that he will bring, to do a very deep dive, if you will, and look very carefully at all of those issues, some of which may result in change, some may not. I can't prejudge that.

So, that is the route for the report itself, in terms of taking it serious, following all of the issues, both through the agreement and the report itself.

Secondly, you ask if there will be changes in governance. In terms of the company's governance and its organization, that is a part of the agreement, and that will be addressed accordingly.

In terms of corporate board governance, I said in my statement, and I really do believe—but I am open always to best practices and we follow these issues religiously—that we are at a point, because of good governance, that we are able to, one, get us this far to keep some stability and calm to a process that I think is very important, to exercise our fiduciary responsibilities in a thoughtful and informed way, and organized ourselves previously to be able to participate in the various teams that are going to be created to fulfill our obligations under the agreement.

One board member has particular expertise in capital markets and the like; Don Marron, formerly of Payne Webber, he will be a very good team person. Another woman, Leslie Rahl, on the board, is a derivatives expert; let her work on those issues.

So, we are organizing ourselves with our expertise. So, I think that is the corporate board governance piece. Whether changes come for board governance from the report, I don't see that right now but I am open to it, but I don't see that.

I think the third issue on compensation, however, obviously we welcome any findings from the independent investigation that address some of the allegations in that area.

As a member of the Comp Committee, we have been addressing, as we look again, at comparables, at best practices, at the structure of compensation, at those in our industry, how to base the bonus plan on more than just earnings per share such as risk and mission factors.

That is going to be forthcoming. So, that is a piece of work that has already been going on but it has been going on because of the marketplace, if you will, in executive compensation.

Chairman BAKER. The gentleman's time has expired. Ms. Waters?

Ms. WATERS. Thank you very much. Would you please give me the correct pronunciation of your name?

Ms. KOROLOGOS. I would be happy to. It is all O's, and it is Ko-ro-lo-gos.

Ms. WATERS. Ms. Korologos. I would like to thank you for coming here today.

I don't know how long you have been here but you may know by now that some of the questions that I raised to Mr. Falcon question the motive of the director as it relates to this so-called investigation.

And I know sometimes that is not a nice thing to do, but I know a lot of history about this ongoing political battle between FM Watch and the GSEs and some of our members' role in all of that.

I also know about the criticisms that were launched at OFHEO and its past oversight or lack of the GSEs. So I have a historical reference for many of the questions that I have asked and some of the accusations that I have may have made.

Having said all of that, you entered into an agreement with OFHEO without having a response from your organization. And it appears that you entered into an agreement because you wanted to show that you were cooperative, that you were not resisting criticism, that if there were problems you wanted to solve them.

It seems to me that is what you did, and you made that decision knowing that some people would not understand that this was not an admission of any kind of guilt or anything else. But I think it is very important for that to be restated time and time that, out of the spirit of cooperation, you entered into this agreement.

Now, I have looked at some aspects of this agreement as represented to us today. And what it appears is that you have entered into agreement that you could easily enter into because, as far as I am concerned, what is being asked of you is not that difficult to begin with, and it may not require you to do any changes at all. You may be correct in some of the things that you are doing.

I don't see any timeframe or time guidelines on any of these points made in the agreement that you should have something done by a certain date, even though we are led to believe this was an emergency.

The board had to be convened right away because these serious accounting problems had been identified and unless you do something right away, the safety and soundness of this organization was at great risk.

But even when I look at the number one recommendation—implement correct accounting treatments that will bring the enterprise into compliance with SFAS 91 and SFAS 133—it didn't say do this in 30 days, in 60 days, in 90 days.

It just puts it out there but nobody says—unless it is someplace else—how the agreement will be made as to what the correct accounting treatments are based on the fact that there are some disagreements, perhaps, about the implementation of SFAS 91 and 133. That is one example.

This other requirement—protect its existing capital surplus and move to a targeted capital surplus equal to 30 percent of its required minimum capital—there is no emergency relative to this requirement.

It didn't say that if you don't do this in 30 days, 60 days, 90 days, something terrible is going to befall this agency. It didn't say that we have come up with this percentage because this is what we have examined, this is what we have looked at and this is the conclusion that we have come to based on these facts.

And, of course, in the spirit of cooperation, you could agree to that, because even though it potentially takes capital away from being involved in some of these good things that you may be doing, it doesn't really admit that something is wrong with the surplus of the minimum capital requirements that you have now—the 18 percent or whatever that is.

So, as I go down each one of these, some of them look a little weak, they look like little smoking mirrors to say that I did an investigation and so now I want you to undertake a top to bottom review of your staff structure.

Duh, I mean, I think this is what you do all the time. And as has been indicated, that even in the ongoing meetings that you have, where people can raise questions, et cetera, et cetera, you are doing this all the time.

So, having said that, would you confirm for me, your understanding of why you entered into this agreement and whether or not you believe that this means that you immediately make great big changes because you were doing something wrong.

Or is this just an agreement to say, "Okay. You want us to look at this? We will be happy to look at it. We believe that we are right and we believe that in the final analysis, we will be proven right."

Explain to us where you are coming from.

Ms. KOROLOGOS. I will.

Chairman BAKER. And that would be the gentlelady's question because her time has expired now. We would be pleased to hear your response.

Ms. KOROLOGOS. Thank you, Mr. Chairman. Yes, it was a very difficult, important period for the board to be presented with an agreement and then, uncertain at the time, the importance of the agreement, per say, because to sign it in 48 hours would not have been possible responsibly.

When, however, we presented, based on the agreement, a work plan, I was able to spend the days with management and say, "What can be done? Let us break this apart and see what can be done on the issues that were raised in the report."

And it really came in sort of three chunks. There were the accounting issues and, clearly as you heard in testimony today, the SEC has a serious role there. There were the capital issues, if you will and the capital plan.

Well that, again, we could bring the best brains together and the talent and work with OFHEO and determine that. And then, I guess you might say, we had also the organizational issues and throughout, we had some very serious allegations that could be addressed by an investigator that OFHEO encouraged us to have.

So, as we broke it apart, we were able to develop a work plan. Having done that that gave us some background, when I understood from the director, or from counsel, they still wanted an agreement and they wanted it really before Monday, the 27th.

I think, in part, from what they told me in preparation for the quarterly letter that they issue regarding our safety and soundness. So that became an issue within the timeframe for this agreement.

The counsels worked together with the board and with me, particularly, on the elements of the agreement. And various changes were made to your point, to make acceptable. There was no way we were going to sign an agreement we couldn't deliver on, number one.

And, number two, we were very eager to get this process going so we could give answers to the public, to our investors, to our shareholders, to the housing community. We had already seen an economic impact because of the swirl and the fire storm we are in.

But how can we stay thoughtful, see through the process of developing an agreement that, one, was responsible, that would further clarify, explain, investigate, in an open way, the issues that had been raised—they were serious—and, at the same time, to your point on timing, not commit to something we couldn't achieve.

You will notice in the agreement—you are right—there are various timeframes, but not necessarily a timeline for delivery. There are 15 days to give the comprehensive plan and seek approval or disapproval of OFHEO.

There are 45 days to have a counsel working for us and conduct reviews. There is a compliance committee requirement and the like. So, there were different timeframes, all of which, in many cases, require OFHEO to approve or disapprove.

My hope is that we will be able to work with OFHEO so their approvals will come in a timely way, too. I think that is an important part of keeping going. We will be developing a tracking system to monitor implementation and our progress.

Now, let me say that it is in our interest to be on two paths here. One is to implement the agreement, the investigation and do so expeditiously because we want to put all of this behind. If there are changes to make, we are happy to make them. If they are allegations that are proven, we need to deal with it.

At the same time, the other track we are on is to run the business. The most important thing we do in this very vibrant, wonderful company with a fabulous public mission is to keep the business going.

So, the more these issues hang around, if you will, I think is irresponsible for the board not to set our own timelines and make sure we can reach them.

That is my best answer to why we did the agreement, what kind of appropriate pressure, if you will, we will keep on the process and the special committee that we created to work on this to oversee it.

The individuals within the company we are selecting to help us there is to keep this moving because we really want to put it behind us. But we want to benefit from the process and do it. As I keep saying, we want to do it right the first time and we want to do it thoughtfully.

So, we are not—I frankly don't want to come back before this committee or our shareholders or our employees and say, "Oh gosh, we didn't do a good job. We have got to redo it." Let us do it right the first time and I think the process we set up will do that.

So, the timelines that will be developed to implement—I am sure there will be some give and take, and that is appropriate with the regulator, and what they think we can do in a certain timeframe and what we think we can do.

I would expect in the spirit of cooperation we will work out that tracking system and those timelines together.

Chairman BAKER. Let me thank you, Ms. Korologos, for your appearance here today and your testimony and also give you an assurance.

Despite the view that the work in the committee may be political in its nature, Mr. Kanjorski and I work very closely together. Our work, especially in this arena, has been bipartisan. We both share the view that strong regulatory capacity is absolutely essential. And we will work as a partner in this process to assist the board in achieving the desired end result.

This does not mean it will be easy or that everyone will always agree on all perspectives. But the public discussion is a good thing, and bring it to speedy resolution is even more important. I think by making the appropriate assurances of good faith on all sides, that we can do something good for homeownership as well as ensuring taxpayers they have no potential liabilities in these matters.

Again, I thank you. I will ask unanimous consent to make a part of the official record, the addendum and reports that you cited in your testimony.

I have documents that were forwarded from OFHEO, the OFHEO report itself, the blue book, and the letter of transmittal of November 12, 2003, to me, of the chart. And I think that is all of the remaining items that need to be officially made part of the record without objection.

And let me express to all participants and my faithful comrades who stayed until 6:11 this evening. Thanks for your good work.

Our meeting stands adjourned.

Ms. WATERS. Thank you very much, Mr. Chairman. And may I—I don't know if I need unanimous consent request to make a request of you relative to our future work.

I don't know if you plan on having more hearings anytime soon, but my request would be that the responses that will be given by Fannie Mae to this investigation be put together, prepared in what-

ever fashion they are going to be and that we use those same responses if we are going to have another hearing.

My suggestion is that we not have a hearing until that is done so that we are all working from the same information.

Chairman BAKER. By way of disclosure for all interested stakeholders, it would be my intent, at this time, to discuss probably over the recess, regulatory reform. I don't know whether there would be a proposal introduced for discussion purposes, but it is not likely, in my view, that this committee would reconvene its work until the next Congress.

With the hope, I think—the long hope for expectation that this Congress will leave town this weekend. If that, in fact, is the case, there would not be the prospect of an additional hearing.

However, to acknowledge the gentlelady's point, at such time as a hearing notice would be issued, I can assure you that any information the enterprise would choose to make part of that hearing process, we would certainly welcome. I would formally ask the chair of the independent board members on any report she would choose to provide to the committee, we would be happy to receive.

And likewise, I am sure; there will be work of independent members during the course of the recess to get us fully prepared to consider whatever ramifications there are from the pending study or regulatory reform or any other issue a member might choose to bring before the committee.

Ms. WATERS. Am I to understand that the Chairman is saying that you possibly will be working on regulatory reform based on the book that has been done by OHFEO already?

Chairman BAKER. No. My view is I have been working on regulatory reform all my life. That effort would just continue into early next year. As you know, we had a proposal in this committee which was very close to being adopted and for whatever reason, did not get adopted.

The Senate has moved the proposal out of Senate Banking Committee, which is now pending. It would be my hope that given—let me take the side of the discussion from those who have been critical of Mr. Falcon and OFHEO.

For those, it would appear it would be likely that you would support a different regulatory structure. For those of us who feel that enhanced oversight is good from a taxpayer perspective, they would support a new regulatory structure.

I don't know anybody today on the committee who expressed objection to the discussion of and passage of a new regulatory structure. So, given that, I think it is our duty to take that up early next year, and in the intervening months, anyone who has suggestions or recommendations, they should be made known and we can take them into consideration.

Ms. WATERS. If I may, Mr. Chairman, I certainly agree that you have been working on regulatory reform for a long time and that the question of whether or not OFHEO was competent to do this certainly has been discussed in this committee.

And some of us, who may have, at one time, supported OFHEO, may be with you on your proposed changes. And what you would like to do with the Treasury Department, I don't know.

But my real question is whether or not you anticipate working on regulatory reform that will respond to some of these allegations that have been surfaced by OFHEO, in the absence of the response that I think we just desperately need to have from Fannie Mae and they have not had the opportunity to present?

That is my question.

Chairman BAKER. I don't see further action by this committee until additional information is provided from both perspectives. I think OFHEO would want the opportunity to respond to the testimony today from Fannie Mae, and it is evident that Fannie Mae would choose to give us more information—the board members as well—as to their findings and factual determinations of the OFHEO allegations.

So, I think both sides are going to be providing members with a lot of information. I am trying to say to the gentlelady, we won't act until there is something that validates acting.

In the interim, we should be working on our regulatory proposal to bring ultimate closure to this whole chapter.

Ms. WATERS. I think I understand that Mr. Chairman. I guess just to wrap this up, what I am really getting at is in the regulatory reform that you have been working on for a long time, we can reasonably anticipate what some of that is all about.

But what I am not certain about is whether or not in that regulatory reform I would look in there and see specific references to this recent OFHEO investigation as it relates to accounting practices that are yet undecided.

Chairman BAKER. That level of analysis would be relegated to the new regulator. I do not see the committee getting engaged in anything other than the principles of oversight. And as I have long said, an independent regulator properly funded with the real authority to assess the enterprise's safety and soundness.

That is it. It has always been the principles. And nothing beyond that need be in legislation, and I think there are any number of proposals I have had in prior sessions, which describe in generality what we would be considering, and those have no reference to the OFHEO analysis of today.

Ms. WATERS. Thank you.

Chairman BAKER. Mr. Scott?

Mr. SCOTT. So, Mr. Chairman, just to make sure we are clear, there will be no movement whatsoever on any regulatory reform until we have this rebuttal process from both OFHEO and Fannie Mae to today's hearings.

Chairman BAKER. Not exactly. What I said was there will be no further action by this committee on this subject matter until conditions warrant action by this subcommittee.

Assume, for the moment, if you wish to pursue this discussion that OFHEO comes back with another troubling report in the next 2 days or the next 2 months. Certainly, the committee would want to receive that report and discuss the findings.

I am not suggesting, however, we would move on a legislative proposal in the next 5 days. There is certainly not time to do so. It would likely be early next year; a reform proposal introduced, would go through due process, all members would be heard, and

certainly the enterprises and all those who have a stake in this matter would be given ample opportunity to voice their opinion.

I don't know exactly the sensitivity that you and the gentlelady are addressing. There is not going to be anything introduced tomorrow that takes page 46 of this report and makes it a new regulation. If that is what you are after.

Mr. SCOTT. You mentioned in the event that there may be another report, is there any indication or evidence on your part that OFHEO is contemplating or putting forward another report?

Chairman BAKER. Oh, no. Let me make it clear one more time. I have no information that any other member does not have. I have had no phone calls from anybody. I asked the director in the public view today, "Mr. Director, what is your next step," hoping that that would send the signal that whatever he told me, he was going to tell you.

Mr. SCOTT. Right.

Chairman BAKER. That is all I know.

Mr. SCOTT. All right.

Chairman BAKER. And when I know more, I will be happy to share it and, in the meantime, I hope I don't see you all until January.

Mr. SCOTT. Thank you.

Chairman BAKER. If there is no further business for this committee, we stand adjourned.

[Whereupon, at 6:19 p.m., the subcommittee was adjourned.]

A P P E N D I X

October 6, 2004

Opening Statement

Congressman Richard Baker

Chairman, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"The OFHEO (Office of Federal Housing Enterprise Oversight) Report: Allegations of accounting and Management Failure at Fannie Mae"
October 6, 2004

The Capital Markets Subcommittee meets today for the purpose of receipt of a report from the Office of Federal Housing Enterprise Oversight. It is indeed a very troubling report. But it is a report of extraordinary importance, to those who wish to own a home, as well as the taxpayers of this country who would pay the cost of cleanup. Although not intended to fuel the effort to bring about regulatory reform, the analysis makes clear that more resources must be brought to bear to insure the highest standards of conduct are not only required, but more importantly, actually met.

For the record, I am not pleased and certainly not happy about these revelations. I am saddened by the disclosures. In all my years of inquiry in this matter, I was only in pursuit of appropriate oversight. Never did I question whether the GSEs were professionally managed to the highest standards of business conduct. Now I do. The culture of mismanagement described in the report must be eliminated and assurances gained that the highest standards of conduct will be consistently practiced.

I know there will be those who will still cling to the belief that the issues raised are minor, or that opinions may differ on technical accounting standards. Some may still think this is all a plot by the big banks to preserve market share. The content of this report cannot be legitimately questioned. Utilizing the firm of Deloitte & Touche, and the staff of OFHEO, the Director's report is delivered after review of over 200,000 documents and e-mails, as well as hundreds of interviews or depositions of current and former staff of Fannie Mae. The statement made in the first page of the Executive Summary unfortunately sums up the circumstance, "The matters detailed in this report are serious and raise concerns regarding the validity of previously reported financial results, the adequacy of regulatory capital, the quality of management supervision, and the overall safety and soundness of the Enterprise."

This finding makes committee action essential.

For the record, I should also note that the resistance the GSEs have expressed toward enhanced housing goals, in light of these revelations, now makes more sense than ever. Should the proposals considered in this committee to focus clearly on the needs of first time homebuyers actually become law, the Enterprise would have to allocate resources to those goals at the expense of reducing earnings. A reduction in earnings would reduce the likelihood of paying out bonuses to executives.

Baker, page two
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This same observation holds true as to the Regulator's decision to increase capital,

and Fannie's strong objections to such a requirement. We all know that the Enterprise is very thinly capitalized, but the potential effect of requiring a responsible capital level would be to adversely affect earnings per share, and consequently make the payment of bonuses much less likely.

I also wish to inform members of the Committee of another troubling incident, which I now choose to make public. About a year ago, I corresponded with the Director's office making inquiry about the levels of executive compensation at the enterprise for the top twenty executives. This is information that had not been made public previously. In a matter of days, Fannie Mae had engaged the services of Mr. Ken Starr for the purpose of informing my staff and committee council of the potential consequences of making that information public. It was made clear that civil legal actions would be filed if the information were to be released. At that time, I made the decision not to release the data since there was no clear relevance to the reform effort underway, not out of concern for any litigation that might be filed. The realization that the disclosure of this information was so sensitive to the Enterprise never fully impacted me, until I read the Director's report. Now I understand why the Enterprise was so anxious not to have public disclosure of compensation of an entity that was created by the Congress, and supported by the taxpayer.

Circumstances have now changed. As a direct result of abhorrent accounting practices, executives have been able to award themselves bonuses they did not earn and did not deserve. For that reason alone, disclosure of where the money went is highly appropriate.

At the conclusion of this hearing, I will release the compensation information obtained from OFHEO and further, I will forward a letter to the regulator requesting that all compensation information for both enterprises be provided for the last ten years for all executives that shared in bonus distributions. This is now essential, in that OFHEO has indicated that accounting manipulation has impacted the financials on more than one occasion, therefore placing the payment of all bonuses in question.

This is very troublesome business. Much is at stake. The ability of this committee and this Congress to act will be called into question. Notwithstanding the ultimate outcome, the facts will remain, and our duty never made more clear.

Opening Statement
Chairman Michael G. Oxley
Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"The OFHEO (Office of Federal Housing Enterprise Oversight) Report: Allegations of Accounting and Management Failure at Fannie Mae"

October 6, 2004

I want to thank Chairman Baker for holding this hearing on the recently released report from OFHEO's special examination of Fannie Mae. He has followed these issues closely and should be commended for his diligent oversight of the GSEs. It is my hope that this hearing will highlight the concerns raised in the OFHEO report and will help Members get to the bottom of the accounting and corporate governance issues at Fannie Mae.

It's unfortunate that we are here today. After earnings smoothing at Freddie Mac was discovered, the public and the markets and the members of the Committee were assured that there were no similar issues at Fannie Mae. The findings in OFHEO's report, if accurate, are disturbing.

While we wait for OFHEO and the Justice Department and the Securities and Exchange Commission to complete their respective tasks, the management and board of directors at Fannie Mae must take real steps to address the issues and continue to cooperate with regulators. The agreement between Fannie Mae and OFHEO is a beginning of that process, but I seriously doubt it can be the end.

Since the enactment of Sarbanes-Oxley two years ago, corporate financial statements have become more transparent and more reliable. There is no question in my mind that the Act is at least partly responsible for this progress. The CEO and CFO certifications of financial statements have had a profound impact on the reporting process.

Other provisions are working, too, such as the Public Company Accounting Oversight Board's inspections regime, strengthened and independent audit committees, officer and director bars, the Fair Funds, expedited disclosures of insider transactions, and internal control requirements, to name just a few. That is not to say that we can legislate integrity in every case. But we do have a sensible framework of incentives and disincentives that will affect behavior.

The OFHEO report raises serious questions about whether Fannie Mae has adequate internal control procedures. The multiple and conflicting duties of the chief financial officer, who we will hear from this morning, calls into question whether there is adequate separation between the risk taking and control functions.

In my view, Section 404 is one of the most important parts of Sarbanes-Oxley. Internal control over financial reporting consists of company policies and procedures that are designed to provide reasonable assurance about the reliability of a company's financial reporting and the preparation of external financial statements in accordance with generally accepted accounting principles.

Failure to comply with its requirements is not an insignificant matter. I am eager to hear from the company's senior management officials on their adherence to this critical provision.

Fannie Mae enjoys certain advantages in the marketplace not afforded to other financial companies in order to serve a public purpose. We have recently learned that the corporate structure may have fostered an atmosphere in which senior management may have had undue influence over accounting policies and procedures, and that corporate earnings and management compensation may have been manipulated.

OFHEO has worked hard in conducting reviews of the GSEs. Director Falcon and his staff have been diligent in trying to ensure that the GSEs receive the appropriate oversight. The findings in this report, if correct, reinforce arguments for the creation of a GSE regulator with the powers and authorities granted to other financial regulators and commensurate with the task of overseeing these large and complicated companies. I was dismayed to learn that OFHEO was forced to resort to issuing subpoenas this past July in order to obtain cooperation with its investigation. It is my sense that if OFHEO had the tools possessed by other regulators this investigation would not have reach the subpoena stage. If we had a GSE regulator with the powers and authority of a world-class regulator, it is possible that these problems at Fannie Mae would have been remedied earlier and today's hearing would not be necessary.

The OFHEO report details problems ranging from possible earnings manipulation to management structures that may not have been in line with state-of-the-art corporate governance. I am very concerned about the possibility that Fannie Mae claims to have sound corporate governance standards, when in reality these standards are not in practice.

Fannie Mae's board did the right thing in entering into an agreement with OFHEO and beginning the process of remedying the problems highlighted in the report. The OFHEO report is not finished and it is my hope that Fannie Mae will cooperate with this investigation as well as the other investigations currently underway at the Securities and Exchange Commission and the Department of Justice. Furthermore, I hope that this situation does not devolve into a war among accountants arguing technical points that do not put to rest the issues raised in the OFHEO report. We owe it to the housing market and to the financial markets to quickly resolve all of the accounting and governance uncertainties.

I want to welcome all the witnesses appearing before the Subcommittee today. I look forward to your testimony.

Statement of Congressman Michael N. Castle

Capital Markets Subcommittee Hearing on
"The OFHEO (Office of Federal Housing Enterprise Oversight) Report:
Allegations of Accounting and Management Failure at Fannie Mae"

October 6, 2004

Thank you Chairman Baker and Ranking Member Kanjorski for holding this hearing before the Capital Markets Subcommittee today. The issue before us is an important one and one that concerns me greatly.

One issue that concerns me is what appears to be the multiple interpretations of Generally Accepted Accounting Principles (GAAP). In February 2004, OFEHO hired Deloitte and Touche LLP to examine the accounting policies at Fannie Mae. Specifically, OFHEO's report finds fault with the company's accounting treatment of (1) the amortization of premiums, discounts, and fees related to the purchase of mortgages and mortgage-backed assets [under Statement of Financial Accounting Standards (SFAS) 91], and (2) financial derivative contracts (under SFAS 133). KPMG LLP, Fannie Mae's auditor has stated it "stands behind" its audit work. Fannie Mae has also stated they believe they were following Generally Accepted Accounting Principles (GAAP).

I am concerned that two different auditors would have different interpretations of SFAS 91 and SFAS 133. Therefore, I have sent a letter to Robert Herz, Chairman of the Financial Accounting Standards Board (FASB), for their comments on SFAS 91 and 133 and whether these standards need to be readdressed or remove any gray areas that may exist.

If improper accounting has occurred, I question how these accounting practices were allowed to occur and what was managements knowledge of these actions. It bothers me greatly to hear the allegation that "accounting tricks" were used to meet specific earnings per share (EPS) targets that resulted in vast amounts of executive compensation to be paid.

I thank all of our witnesses for appearing before us today, and I hope we will have an exchange on the merits of what has occurred and what needs to occur in the future. I welcomed the news that OFHEO and Fannie Mae reached an agreement to address the improper accounting and internal controls within Fannie Mae. I strongly believe, however, that like the reforms achieved in the passage of the historic Sarbanes-Oxley Act we must again be prepared to act.

Mr. Chairman, I would like to insert the text of my letter to Chairman Herz for the record, and with that I yield back the balance of my time.

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before the
Subcommittee on Capital markets, Insurance, and Government Sponsored Enterprises
"The OFHEO (Office of Federal Housing Enterprise Oversight) Report: Allegations of Accounting and Management Failure at Fannie Mae"

Mr. Chairman, We are rushing to judgment today. OFHEO has released a preliminary report which has not been proven, but leaked to the press. During the course of the examination, Fannie Mae was not given the chance to respond to OFHEO findings. Informal communications, which are at the core of the GSE's oversight statute, were essentially ignored. At least one former examiner at OFHEO questioned the political motivations behind OFHEO's rush to judgment.

Mr. Chairman, we do not normally hold hearings on matters before other investigations are complete. Internal findings are normally discussed informally and remedies proposed. There are other stages of this process that take place before judgment is rendered. Why circumvent the process? Why this hearing? If I were a member of Fannie's Mae's board, I would find the environment very intimidating. Mr. Chairman, why is Senator Shelby not holding a hearing on this preliminary report? After all, the Senate Banking Committee reported out legislation on the GSEs. Maybe this hearing agenda is about something more than the accounting procedures at Fannie Mae.

As you know, Fannie Mae recently entered into an agreement with OFHEO in which they focused on accounting, internal control, and capital. Fannie Mae has agreed to increase additional capital by 30 percent – I'm not sure how the new requirement promotes affordable housing – within 45 days, OFHEO and Fannie Mae will implement additional internal controls.

The Securities and Exchange Commission (SEC), as is intended, should be the final arbiter of GAAP. Why can't we let the SEC decide this issue? Why must we rush past them?

This hearing is about the political lynching of Franklin Raines. We have seen this happen too many times before. We are to go out of session and the deed is to be done before the election. Why can't we just say that this is the agenda? Let us debate that issue on its own merit. Better still, let due process take its course and let the chips then fall where they may. That is, unless this is truly a witch-hunt.

We are having a trial by OFHEO leaks; trial by newspaper articles; and trial without due process. In this case the Senate has it right!

Statement of the Honorable Harold Ford

Subcommittee on Capital Markets, Insurance, and Government Enterprises
"The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae"
October 6, 2004

Thank you Chairman Baker, and Ranking Member Kanjorski for holding this hearing regarding to consider the OFHEO Report and these serious allegations against Fannie Mae.

The subcommittee correctly convened with due speed to probe the ramifications of the OFHEO report, Fannie Mae's response to this report, and the profound implications for what remains the most steadfast and brightest part of the United States economy — homeownership.

Unfortunately, we should not have to be here. Not because of the OFHEO Report. Not because of any failure at Fannie Mae.

Rather, the full committee was well on the way to a consensus reform package for the GSE's only to have that bipartisan momentum undercut by the Administration's agenda to completely remake our mortgage finance system

Mr. Chairman. Fool me once shame on you. Fool me twice shame on me. With all due respect to Director Falcon, OFHEO should not be in this position. We need an independent arbiter capable of making a definitive determination about these accounting practices. Instead, we have a dispute between accounting firms - Deloitte and Touche and KPMG - about practices that few if any on this committee (or in this Congress for that matter) understand.

The result is that we are left to look at the SEC for leadership and to act as a referee in this battle between accountants and compliance with GAAP. Regrettably, OFHEO did not reach out to the SEC during this process, a fact this is as troubling as is OFHEO ability to carry out its responsibilities is questioned by many.

Having been through this with Freddie Mac's accounting problems and the significant restatement of earnings that followed, the easy thing would be to blame the GSE's. Opponents of this structure are saying here they go again manipulating the market because of their implicit government guarantee.

Instead we should be looking at our own failures and the Administration's unwillingness to ensure that the Housing mission is vital toward the sustained vitality of the mortgage finance system. Fannie Mae was chartered by Congress to ensure that Americans have access to mortgage funds at the lowest cost.

Fannie Mae has fulfilled this mission. However, there are serious questions as to whether low and middle-income homeowners' interests have been usurped by shareholders.

Today is an important first step in answering that threshold question. Today is also an important step in ascertaining whether Congress created an environment that allowed that to happen.

At the same time, we need to also consider the capacity of OFHEO to fulfill this mission in an environment where extraordinary complex financial transactions are used to manage the issuance of capital and debt.

Where was OFHEO in 1998 when Fannie allegedly used these derivatives to meet earnings targets? Where has OFHEO been all these years, a true world class regulator should have found these alleged improprieties long ago?

As recently as 2002, OFHEO has said Fannie Mae's implementation of FAS 133, one of the accounting methods in question, was exemplary. Specifically, the implementation was "deliberate" and "well-documented." In 2002, the implementation was superb and now this committee is told that profit smoothing and improper accounting occurred. Which is it?

Congress should take a cautious approach and let the facts of the pending investigations speak. There should not be a rush to judgment on this matter, for the OFHEO report we are discussing today is only preliminary.

In addition to the SEC, we are well aware of an investigation by the Justice Department. Until all the facts are in, the best course of action will not be known. While a quick resolution is desired by many, one that does fails to look at the GSE's and its regulator sets this body up for another problem down the road.

Congressman

PAUL GILLMOR

Ohio's Fifth Congressional District

FOR IMMEDIATE RELEASE
Wednesday, October 06, 2004

Contact: Bradley Mascho
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Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

WASHINGTON, DC- Congressman Paul E. Gillmor (R-Old Fort) released the following statement today during a hearing of the House Financial Services Committee's Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises entitled "The OFHEO (Office of Federal Housing Enterprise Oversight) Report: Allegations of Accounting and Management Failure at Fannie Mae":

Thank you, Mr. Chairman, for calling this hearing and for your continued leadership on this important issue.

Mr. Chairman, I am disappointed that we are here this morning to discuss yet another case of accounting irregularities and failed corporate governance, this time involving a company endowed with the public trust.

On September 17, 2004 the Office of Federal Housing Enterprise Oversight (OFEHO) released a report of its findings from their special examination of Fannie Mae. The report determined that Fannie Mae applied accounting methods and practices that did not comply with certain Generally Accepted Accounting Principles (GAAP) or GAAP rules, did not have proper corporate governance controls in place, and utilized an improper "cookie jar" reserve system while deferring expenses reportedly to meet compensation targets.

In fact, if the information we received is accurate, it appears that management "cooked the books" to enrich themselves by unjustified bonuses at the expense of shareholders and borrowers.

In light of these reports and the previous earnings restatements necessary at Freddie Mac, I hope we can have a full discussion today on the continued need for stronger supervision through a new regulator for these Government Sponsored Enterprises (GSEs). The housing GSEs were created to fulfill a public mission and support our housing market. Fannie Mae alone has almost $1 trillion in debt tied to taxpayers and we can no longer ignore the serious threats to their safety and soundness that have been uncovered but were not prevented by a strong regulator.

As an original cosponsor of HR 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act, I am disappointed that we have not yet been able to pass this important reform legislation but hope that the revelations of accounting and corporate governance problems at Fannie Mae will give greater urgency to our discussion of this important issue.

Thank you again, Mr. Chairman, for scheduling this hearing and I look forward to an informative and thorough discussion.

# # #

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE REPORT AND FINDINGS TO DATE OF THE SPECIAL EXAMINATION OF FANNIE MAE

WEDNESDAY, OCTOBER 6, 2004

Mr. Chairman, we meet today for what might well be our last hearing this year. At our first hearing in 2004, we reviewed the special examination of Freddie Mac by the Office of Federal Housing Enterprise Oversight. It therefore seems fitting that we will bookend our hearings this year with an evaluation of the findings to date of a similar examination of Fannie Mae's accounting policies and practices.

The recently released preliminary report by the Office of Federal Housing Enterprise Oversight includes a number of significant charges. The report concludes that Fannie Mae has failed to follow generally accepted accounting practices in two key areas. They are the accounting of derivatives contracts and the amortization of discounts, premiums and fees involved in the purchase of home mortgages.

The report also raises concerns about the company's organizational structure and its internal controls. These are serious matters that merit our careful attention, because government-sponsored enterprises with their public responsibilities and private capital have, in my view, a special obligation to operate fairly, safely and soundly.

As we proceed today, I must urge my colleagues on both sides of the aisle to demonstrate patience and caution when approaching these matters. We should not leap to immediate conclusions. The report on Fannie Mae is preliminary. It is part of an ongoing process.

We should not overanalyze these findings because we do not have all of the information. Fannie Mae's board, as I understand, has already agreed to adopt a number of reforms based on this initial report and it may ultimately implement more. The Office of Federal Housing Enterprise Oversight continues to examine the company's books. The Securities and Exchange Commission, the arbiter of accounting standards for Fannie Mae, is now studying these matters. In short, we need to let this process work itself out.

We should also refrain from hyping these initial findings in an effort to achieve some short-term political gain. As we well know from past experiences, our actions and statements on Capitol Hill have the potential to rile the capital markets. They could also raise the price of homeownership. We should therefore practice caution, prudence and discretion.

My primary focus at today's hearing will be to determine whether the issues raised in the preliminary report constitute some form of systemic risk for Fannie Mae. I therefore intend to ask each of the witnesses their perceptions regarding this issue. I expect them each to offer me their candid assessments of these matters.

As we proceed today, I also suspect that some of my colleagues will return to the question of how best to modify the regulation of government-sponsored enterprises like Fannie Mae and Freddie Mac. As I said at our very first hearing on the oversight of government-

-more-

sponsored enterprises in March 2000, "we need to have strong, independent regulators that have the resources they need to get the job done." I can assure everyone involved in these debates that I continue to support strong, world-class and independent GSE regulation.

A strong, world-class and independent regulator will protect the continued viability of our capital markets and promote confidence in Fannie Mae and Freddie Mac. It will also insure taxpayers against systemic risk and expand housing opportunities for all Americans.

Like many of my colleagues, I was greatly disappointed last year when the Bush Administration rejected our bipartisan efforts to create an independent regulator. Politics, in my view, should play no role in financial regulation. It is therefore my hope that when we revisit this issue in the 109th Congress we will continue to remain resolute and unwavering in our bipartisan efforts to create a strong, independent and world-class regulator with the powers and resources it needs to get the job done.

In closing, Mr. Chairman, I commend you for your sustained leadership in these matters and for convening this timely hearing. The preliminary report by the Office of Federal Housing Enterprise Oversight and its agreement with Fannie Mae deserve careful review and public scrutiny. I consequently look forward to hearing from our witnesses today.

GARY G. MILLER
42ND DISTRICT, CALIFORNIA
ASSISTANT WHIP AT LARGE
COMMITTEE ON FINANCIAL SERVICES
COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE
BUILDING A BETTER AMERICA CAUCUS, CHAIRMAN

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Statement of Congressman Gary G. Miller
Hearing on "The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae."
Committee on Financial Services, Subcommittee on Capital Markets
October 6, 2004

I would like to thank the Chairman for his continued commitment to ensuring the safety and soundness of the secondary mortgage market. The question of impropriety that has surfaced as a result of allegations of accounting irregularities at Fannie Mae has sent shockwaves through the strong housing finance markets.

The United States housing markets are the envy of the world. We enjoy the lowest interest rates and the highest homeownership rates of any developed nation in the world. When Americans are homeowners, it spurs economic and community development and provides residents with a sense of pride in their community. Homeownership is the single largest creator of wealth for most Americans. For these reasons, it is imperative that we work through this process to maintain a strong housing market.

Government Sponsored Enterprises (GSEs) have been at the forefront of creating affordable housing opportunities for American families. In my district, for example, Fannie Mae has created employer-assisted housing programs for the City of Brea Police Department to allow police officers to live in the communities they serve. They have helped to finance affordable housing initiatives in Anaheim, California. Across the district, they have been able to offer innovative programs to allow those with blemished credit to afford the dream of homeownership, to help seniors convert the equity in their homes into cash to help them meet their needs, and to help families and individuals with special needs become homeowners. All of this, in partnership with lenders, is intended to meet the ever-growing needs of our communities.

As we address deficiencies in GSE supervision, we must not lose sight of Congress' original goal in chartering GSEs. The mission of Fannie Mae and Freddie Mac is to provide stability and on-going assistance to the secondary market for residential mortgages, and to promote access to mortgage credit and homeownership in the United States. As we move forward to make much-needed regulatory reforms to ensure the safety and soundness of the GSEs, Congress must be unwavering in our commitment to help Americans achieve the dream of homeownership and continue to ensure the accessibility of mortgage funds at the lowest cost. We must completely understand the implications of changes to the regulatory structure in meeting the goals of the charter, being careful not to inadvertently hinder the ability of GSEs to be innovative in meeting the needs of potential homebuyers.

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I believe Congress has ample evidence that OFHEO may not have the expertise necessary to appropriately regulate complex financial institutions such as Fannie Mae and Freddie Mac. OFHEO released annual reports that the internal and external audit functions at Fannie Mae exceeded safety and soundness standards and had the appropriate independence. How can we be confident in such findings when OFHEO is now issuing a new report with very different, troubling findings about serious accounting irregularities at Fannie Mae?

We must work to create a new regulatory regime under which investors and the markets can be confident that these companies are sound and that their investments in America's housing markets are safe. While there is no question that regulatory changes must be made to ensure that the GSEs are held to the absolute highest standards of ethics and conduct, I urge my colleagues to remain mindful that strong regulation provides a means to achieve our ultimate goal of expanding the supply of affordable mortgage credit across this nation.

Again, Mr. Chairman, I thank you for holding this hearing. The goals of these two companies is so critical to the economy and I look forward to working with you to ensure appropriate regulatory reforms are made.

THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES U.S. HOUSE OF REPRESENTATIVES

STATEMENT OF ARMANDO FALCON, JR. DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

"REPORT OF FINDINGS TO DATE, SPECIAL EXAMINATION OF FANNIE MAE"

OCTOBER 6, 2004

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee; thank you for inviting me to testify about OFHEO's special examination of Fannie Mae. As always, my testimony reflects my own views, and not necessarily those of the Secretary of HUD or those of the President.

Before getting to my comments on the report, I'd like to introduce two of my staff. On my right is Chris Dickerson, OFHEO's chief compliance examiner and one of our derivatives experts. On my left is Wanda Deleo, our chief accountant. Both are leading the work of the special examination and are here to assist me in answering technical questions on the report.

Background

In July of last year, I announced that OFHEO would conduct a special examination of Fannie Mae's accounting policies, internal controls and financial reporting. While the special examination continues, our safety and soundness mandate requires that when we find problems, we move quickly to remedy them, rather than wait until the entire examination is complete. The report represents our findings to date, and it serves as the basis for the actions we have taken.

The report raised such serious safety and soundness concerns that we brought them to the immediate attention of the Board. To the Board's credit, it became very engaged in the examination, and moved quickly to reach an agreement with OFHEO on a plan of remediation. The agreement constitutes an important first step toward resolving OFHEO's concerns and ensuring safe and sound operations at the Enterprise.

Report on Findings to Date

Let me turn now to the substance of the report. It documents Fannie Mae's pervasive and willful misapplication of Generally Accepted Accounting Principles as well as critical operational deficiencies. The report's findings have implications in four areas of major concern to OFHEO:

1. the validity of Fannie Mae's previously reported financial results;

2. the adequacy of its regulatory capital;

3. the quality of senior management's supervision of the Enterprise; and

4. Fannie Mae's overall safety and soundness.

The accounting problems OFHEO identified focus on two critical areas: 1) premiums, discounts and deferred price adjustments associated with mortgages and mortgage-backed securities; and 2) derivatives and hedging activities.

In developing accounting policies and practices in these critical areas, Fannie Mae violated GAAP, specifically SFAS 91 and SFAS 133.

The accounting violations cannot be dismissed as mere differences of interpretation in accounting rules. Fannie Mae understood the rules and simply chose not to follow them.

Fannie Mae's development of improper accounting policies and practices can be traced back to a corporate culture and operating conditions characterized by the following:

- a desire on the part of senior management to portray Fannie Mae as a consistent generator of stable and growing earnings;
- an ineffective process for developing accounting policies;
- an operating environment that tolerated weak or non-existent internal controls;
- key person dependencies and poor segregation of duties;
- incomplete and ineffective reviews by the Enterprise's office of auditing;
- an inordinate concentration of responsibility vested in the chief financial officer; and
- an executive compensation structure that rewarded senior management for meeting goals tied to earnings-per-share, a metric that can be subjected to senior management manipulation.

SFAS 91

The accounting problems at Fannie Mae that OFHEO has uncovered relate mainly to SFAS 91 and SFAS 133. Let me briefly describe each.

SFAS 91 applies to accounting areas critical to Fannie Mae's business. SFAS 91 governs the amortization of balances related to mortgages and mortgage-related securities including premiums and discounts, and buy-ups and buy-downs on guarantee fees.

Senior management developed accounting policies and selected and applied accounting methods to improperly reduce earnings volatility related to amortization. Fannie Mae improperly delayed the recognition of income to create a "cookie jar" reserve that it could dip into whenever it best served the interests of senior management. Those interests included smoothing earnings and meeting earnings-per-share targets linked to executive bonuses.

An important example of how this worked took place in 1998 when external events caused a plunge in interest rates, which in turn led to an acceleration of mortgage prepayments. As a result, Fannie Mae faced a more rapid premium amortization in the Enterprise's mortgage portfolio than expected.

In December, management's own amortization models specified that $400 million in premium amortization expenses had to be recorded on Fannie's books in 1998. However, management decided to record only $200 million that year. Fannie Mae deferred the remaining $200 million to 1999, and recorded it incrementally throughout that year. KPMG, Fannie's outside auditor, cited the Enterprise's action on this matter as an "audit difference," a term which means KPMG disagreed with Fannie Mae.

Had Fannie Mae taken the full $400 million charge in 1998, senior managers would have lost their eligibility for any bonuses. Incentive compensation depended on Fannie Mae realizing earnings-per-share targets. As it happened, the earnings-per-share target which would secure senior management the maximum bonus could only be reached if Fannie Mae recorded no more than $200 million of the expenses in 1998.

The next year, Fannie Mae kicked off a "challenge grant initiative," which promised to reward management for doubling earnings in five years. To avoid facing amortization problems similar to those of 1998 again, senior management began a prolonged and concerted effort to develop policies for managing the amortization of deferred price adjustments, premiums, and discounts. The goal was to gain earnings flexibility and the ability to minimize earnings volatility. In this regard, the 1998 violation was not a singular event; it represented the start of a continuous effort to artificially guarantee success in meeting targets.

The amortization policies adopted rested on two main concepts:

1. not recognizing estimated income or expense below certain thresholds, and

2. deferring (often up to several years) the recognition of income or expense which exceeded recommended thresholds, to more advantageous reporting periods.

These concepts – and the policies and accounting methods Fannie Mae adopted based on them – are not supported by SFAS 91 specifically or GAAP more broadly.

In examining Fannie Mae's amortization modeling, we found that management produced multiple amortization runs, using a wide range of assumptions for future interest rates and prepayment speeds. The goal was to find a way to achieve desired outcomes.

We also found numerous instances where the impacts of other accounting events were capitalized as phantom assets or liabilities within the amortization system. Fannie Mae later amortized them as if they were attached to 30-year fixed-rate mortgages. By doing so, management inappropriately shifted income or expense from one period to others thereby dampening earnings volatility.

Moreover, Fannie Mae's written procedures and documentation for most of its amortization activities have been inadequate. The limited documentation and audit trails for amortization processes and systems allow Fannie Mae to manage its earnings and volatility in such a way that proper regulatory oversight can be impeded. Such behavior is a major safety and soundness concern.

SFAS 133

Let me now turn to SFAS 133 and hedge accounting. SFAS 133 requires that derivatives be marked to market, and that changes in fair value be included in earnings unless the derivative is designated as and qualifies for hedge accounting.

We have found that Fannie Mae implemented SFAS 133 in a manner that appears to have placed minimizing earnings volatility and maintaining simplicity of operations above compliance with GAAP. These goals, to an inordinate degree, influenced the development of Fannie Mae's approach to hedge accounting.

Fannie Mae's hedge accounting assumes that the vast majority of its hedging relationships are "perfectly effective." In other words, the risk and the hedge are perfectly matched, and there is no exposure to loss. A hedge relationship that is not "perfect" must be measured for its imperfection in order to determine the amount of exposure the Enterprise faces and to accurately place the timing of gains and losses. Compliance with this accounting rule is important in determining the safety and soundness of Fannie Mae.

SFAS 133 does allow the assumption of perfect effectiveness, but only in very limited circumstances. Assuming perfect effectiveness is the exception rather than the rule.

By improperly assuming perfect effectiveness for many of its hedges, Fannie Mae has failed to perform the proper assessment of effectiveness and measurement of ineffectiveness. Furthermore, the Enterprise has many deficiencies in its hedge designation documentation.

Effectiveness assessment, ineffectiveness measurement, and proper hedge documentation are critical prerequisites for receiving hedge accounting treatment. Because Fannie Mae has not met these criteria, it should not receive hedge accounting treatment for many of its derivatives. Instead, proper accounting for such derivatives requires that their fair value changes be recorded directly through earnings.

In a related area, prior to 2004, Fannie improperly accounted for certain offsetting derivatives, treating them as hedges when the derivative did not qualify as such.

Moreover, from the time SFAS 133 was adopted in 2001 through the third quarter of 2002, Fannie Mae improperly accounted for certain purchased interest rate caps. The Enterprise applied an inconsistent methodology in determining the time and intrinsic values of these instruments.

As a result of these issues and Fannie Mae's disregard for complying with SFAS 133 in accounting for its hedging activities, we are

concerned about the validity of the amounts Fannie Mae has reported in what is called Accumulated Other Comprehensive Income, the earnings the Enterprise has presented in prior quarters, and the adequacy of regulatory capital.

As of December 31, 2003, the balance in AOCI included roughly $12.2 billion in deferred losses relating to derivatives. In addition, adjustments to the carrying value of liabilities relating to fair value hedges amounted to $7.2 billion as of that date.

The reclassification of amounts out of AOCI and into retained earnings could have a significant effect on Fannie Mae's regulatory capital, which is a crucial safety and soundness concern.

Internal Controls and Management Deficiencies

OFHEO found that Fannie Mae maintained a deficient accounting policy development process, key person dependencies, and poor segregation of duties – all of which contributed in important ways to the Enterprise's accounting problems.

In our examination, we evaluated the roles and responsibilities of the chief financial officer, executives in the controller's division, and the controls that support the integrity of the financial reporting process.

Our report documents how management failed to establish an internal control system to ensure accounting policies were appropriately developed and reviewed. For example, we found that Fannie Mae's "Purchase Premium and Discount Amortization Policy" was developed without input from the Enterprise's financial standards office. That is the group in the controller's division usually responsible for setting accounting policy. Indeed, the head of that group testified that key provisions of that document did not comply with GAAP.

We found numerous instances of key person dependencies and inadequate segregation of duties. For example, the chief financial officer also serves as the chief risk officer. He is also directly

responsible for overseeing the treasury and portfolio management functions, as well as the controller's division. The concentration of these responsibilities in a single person does not provide the independence necessary for an effective chief risk officer function.

Agreement with Fannie Mae's Board of Directors

Because OFHEO's special examination uncovered so many serious problems at Fannie Mae – with such serious implications for the safety and soundness of the Enterprise – we took prompt and appropriate action.

We entered into an agreement with the Board requiring that Fannie Mae:

- implement correct accounting treatments that will bring the Enterprise into compliance with SFAS 91 and SFAS 133 accounting standards;
- protect its existing capital surplus and move to a targeted capital surplus equal to 30% of its required minimum capital;
- recalculate its accounting under SFAS 91 for all quarterly periods beginning in 1998 and SFAS 133 for all quarterly periods beginning in 2001 for previously reported financial statements;
- undertake a top-to-bottom review of staff structure, responsibilities, independence of functions, compensation and incentives;
- appoint an independent chief risk officer, and separate other key business functions currently performed jointly by certain individuals or departments;
- put in place policies to assure adherence to accounting rules and new internal controls.

I must remind the Subcommittee that the special examination is continuing. If OFHEO discovers more problems, we may take further action.

Finally, I want to thank the leadership of the Full Committee and of the Subcommittee for your support for our funding. The current

Continuing Resolution has placed severe constraints on our ability to hire additional staff and employ outside experts for the Fannie Mae special examination. This could not come at a worse time for the agency and it once again illustrates the need to remove OFHEO from the appropriations process.

Thank you. We will be pleased to answer any questions you may have.

EMBARGOED UNTIL:
10 am OCTOBER 6, 2004

Testimony by
Timothy Howard, Vice Chairman and
Chief Financial Officer, Fannie Mae
Before the House Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
October 6, 2004

Good morning, Chairman Oxley, Ranking Member Frank, Chairman Baker and Ranking Member Kanjorski and members of the Subcommittee. I thank you for inviting me to be here today.

I joined Fannie Mae in 1982, when the company was in the midst of a severe financial crisis brought on by flaws in its interest rate risk management. Under the leadership of David Maxwell we were able to turn the company around and establish the solid financial footing that has enabled Fannie Mae to reliably provide hundreds of billions of dollars in affordable, fixed-rate mortgage financing to millions of low, moderate and middle-income Americans. I consider it a privilege to have been able to devote the past 22 years of my career to this company and its mission. Throughout this time I have tried my absolute best to do the right thing for the homebuyers Fannie Mae helps to serve, the employees I lead, and the investors who have placed their trust in our company.

All of my judgments regarding accounting issues were made in openness and good faith, with the goal of providing investors with the most meaningful and understandable information possible. When accounting issues arose I worked with the head of my accounting policy group, who I know to be knowledgeable and highly respected in the industry. I also made certain that any accounting approaches we adopted were reviewed with our outside auditor.

I had a clear objective in guiding Fannie Mae's implementation of the two accounting standards that are at issue in the OFHEO report – FAS 133 and FAS 91. And that was to preserve the accuracy and utility to investors of our financial statements by reporting on what I honestly believed were the true economics of our business. At all times I believed that the accounting applications we adopted were within the boundaries defined by GAAP, as interpreted and understood by our accounting experts both inside and outside the company.

We filed financial statements with the SEC that were fully audited by KPMG, and as Frank Raines said, Fannie Mae has not withdrawn those financial statements and KPMG has not withdrawn its opinion that those financial statements were prepared consistent with GAAP in all material respects.

FAS 133 is widely considered to be the most complicated accounting standard ever issued. Its implementation had the potential to greatly reduce the clarity and utility of Fannie Mae's financial statements. We recognized this challenge from the outset, but we did not attempt either to circumvent the standard or to violate GAAP to deal with it. Instead, we developed a separate earnings measure – core business earnings – to convey to investors our financial results in the absence of FAS 133.

FAS 91 requires that we estimate the average lives of the mortgages in our portfolio to determine the rates at which premiums or discounts on these mortgages should be amortized into our income statement. By definition this estimation process is imprecise. From the inception of FAS 91 in the late 1980s, we have used ranges to address the imprecision inherent in estimating mortgage prepayments. KPMG concurred with our use of a range.

Ultimately, the SEC will resolve the issue as to whether our implementation of FAS 133 and FAS 91 is consistent with GAAP. This is entirely appropriate, and I look forward to receiving the results of their review. It is important to note, however, that the matters to be reviewed relate to accounting judgments and not issues of risk management. Financially, Fannie Mae is as strong as ever, and our ability to carry out our mission remains intact.

I look forward to responding to your questions on these matters.

Statement of Ann McLaughlin Korologos
Presiding Director of the Board of Directors of Fannie Mae
Before the
Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee
Of the House Financial Services Committee
October 6, 2004

Introduction

Thank you Chairman Oxley, Ranking Member Frank, Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. My name is Ann Korologos, and I am the Presiding Director of Fannie Mae's Board of Directors. I also currently serve as the Chair of Nominating and Corporate Governance Committee and on the Compensation Committee. I am a shareholder-elected, independent director.

I welcome this opportunity to speak on behalf of the Board regarding the OFHEO Report of Findings to Date in the Special Examination (the "Report") issued to the public on September 22. I want to thank the Committee for holding this hearing.

The Board takes the issues raised by the OFHEO Report very seriously. We are here to do the right thing, and by that I mean: to respond to OFHEO, the SEC, and Congress, and do so in a way that protects the shareholders and restores confidence. In this way, the Company can continue to fulfill its critical housing mission – to use the financial flexibility of a private company to pursue the societal goals of increased homeownership.

In my opening statement, I would like to focus directly on how the Board has responded to the OFHEO Report, including the agreement we have reached with OFHEO, and the important work we will do going forward to properly resolve the issues raised in the Report.

Most importantly, let me assure you that the Board takes the issues raised in the OFHEO Report seriously and is fully committed to addressing and resolving them expeditiously and appropriately. We will do it right the first time, and we will be held accountable.

The Board Took Action Immediately to Respond to OFHEO's Report

The Board has actively participated through our Audit Committee in overseeing the Company's response to the examination since it began over a year ago. We have received regular reports from the Committee on the examination's progress.

Upon receiving the Report, the Board acted immediately to examine and respond to OFHEO's findings. We are moving quickly to address the complex accounting, internal control, and other issues raised by the Report. The Board has demonstrated its commitment to our oversight and fiduciary responsibilities, by swiftly working to reach

agreement with OFHEO to put into place a process that will thoughtfully and carefully resolve these issues.

As a board of directors, we must meet our fiduciary duties of loyalty, care, and good faith. These duties have meaning. We do not take these responsibilities lightly. They require us to gather the facts, conduct an objective investigation, and render judgment based on the facts. We must look at the issues in the Report deeply, thoughtfully, and carefully, using whatever resources are necessary. Every board of directors is subject to these duties but even more so at Fannie Mae because we have a mission to serve the public: our shareholders, investors, homeowners, renters, and their communities. We believe our actions demonstrate the Board's seriousness in responding to the Report.

Less than three weeks ago, on Friday afternoon, September 17, Director Falcon contacted me to say that OFHEO wished to share its findings to date with the outside directors on the Board. I immediately convened a meeting of the Board for the next business day, Monday, September 20.

Despite the short notice, every non-management director attended in person or by telephone. Director Falcon's senior staff presented the OFHEO Report to us and the Company's outside counsel. During the approximately two hour meeting, OFHEO's senior staff made a presentation on the Report and provided the Board a draft agreement to be entered into over next 48 hours. This meeting was the Board's first exposure to the Report. OFHEO proposed that the Board conduct an independent review by lawyers and accountants of the issues and questions raised by the Report.

I assured Director Falcon on the morning of Tuesday, September 21, that the Board would work cooperatively and openly with OFHEO and its staff. I expressed the Board's hope that this work together would set a model for a constructive relationship built on mutual respect and trust going forward. I told him, however, that the Board could not, consistent with its fiduciary responsibilities, sign a document in 48 hours. During this conversation, the Director assured me that the draft agreement presented on September 20 was intended to ascertain the Board's seriousness.

I informed the Director that I had been authorized to hire former Senator Warren Rudman and his law firm, Paul, Weiss Rifkind, Wharton & Garrison LLP, subject to OFHEO approval, to conduct the Board's independent review. I also advised Director Falcon that we would provide him on the following day a draft work plan, based on OFHEO's draft agreement, of actions we and the Company would take to address all of OFHEO's concerns.

That same day, I worked with management to develop a work plan based on actions required by OFHEO's draft agreement to present to OFHEO within their 48 hour deadline. The Board convened and approved the work plan.

And so, two business days after receiving the Report, on Wednesday, September 22, I presented to Director Falcon, on behalf of the Board, the draft work plan. I have attached a copy of this plan to this statement.

After reviewing the draft work plan, Director Falcon told me later that evening that he thought the work plan was substantive and addressed each of the areas of concern raised by the Report. On Thursday, in a conversation with OFHEO's General Counsel, however, it became clear that OFHEO wanted a written agreement with the Board. The Board met again that evening, September 23, and directed the Company to do their best to reach an agreement with OFHEO.

On Friday, September 24, the Company's counsel began meeting with OFHEO to reach the contents of such an agreement. Discussions continued throughout the weekend. After this series of meetings and two Board meetings on Sunday, September 26, Fannie Mae and OFHEO announced the September 27 written agreement outlining our next steps.

The September 27 Agreement Guides Our Work Going Forward

As I said in announcing the agreement, the Board is pleased to have worked cooperatively with the Director and staff of OFHEO. I thanked the Director and his staff for their accessibility and noted that these are significant steps and the Board is fully committed to their timely implementation.

The agreement is only the beginning of what will be a thorough process to implement changes at Fannie Mae that address OFHEO's concerns. Management has pledged its cooperation to the Board in undertaking these reviews and changes, and the Board will hold management accountable to that pledge. The Board will supervise the entire process, with a number of Board members following closely those areas in which they have expertise and experience.

Under the agreement, Fannie Mae will take a series of steps with respect to its internal controls, organization and staffing, accounting, and capital. The Company will hire a Chief Risk Officer and structure the responsibilities of that office in accordance with OFHEO's guidance and best practices in the industry. The Board is already undertaking a nationwide search to ensure we bring in an experienced and talented person for that job. The Company will modify its implementation of FAS 133 and FAS 91 going forward. The Company is developing a capital plan under which the Company will achieve a capital surplus of 30 percent within the next 270 days.

Finally, the Board has hired, and OFHEO has approved, independent counsel former Senator Warren Rudman and his law firm, who will in turn hire independent accountants also subject to the approval of OFHEO. We expect Senator Rudman to conduct his independent review as described in our agreement with OFHEO and to report his findings to the Board, OFHEO, and the SEC for resolution. The independent review will also make recommendations with regard to staff structure, function and

compensation, as well as the implementation of policies to ensure adherence to new accounting treatment and internal controls.

The Company and its outside auditors have a disagreement with OFHEO about some aspects of implementation of FAS 133 and FAS 91. To date, that difference has not been resolved. The agreement sets up a process going forward to resolve these issues. The SEC will determine what is and is not compliant with GAAP. The SEC has not prejudged these issues. As anyone who reads the Report can tell, these are very complex accounting issues.

Let me assure you, Mr. Chairman and members of the committee, Fannie Mae's Board will closely supervise the adoption of each element of the agreement. We will work diligently with the independent review to ensure a timely resolution of the remaining issues. The Board is not going to prejudge, and I respectfully urge you not to prejudge, the outcome of Senator Rudman's independent review. We must allow this process to go forward before we draw conclusions, assign motive, render verdict, and determine accountability.

The Board's Deep Experience in Business and Government

I have known some of you over the years, from my experiences in both public service and the private sector, and I think you know my commitment to ensuring that our laws are upheld and the institutions of our economy maintain the highest levels of integrity.

I have served in three Cabinet Departments, including as Secretary of Labor under President Ronald Reagan, and I headed the Presidential Commission on Aviation Security and Terrorism specifically investigating the bombing of Pan American Airways Flight 103.

I currently serve on a number of other corporate boards. I am the Chairman of the RAND Corporation, a nonprofit organization. I am also a member of the Board of Overseers of the Wharton School of the University of Pennsylvania.

We believe we have built a sturdy corporate governance structure to be prepared for any challenge this organization may face. How this Board and the Company handle themselves when things go wrong is the ultimate character test. We have benchmarked our governance against other companies. Our non-management directors meet as a group, without management, every time the full Board meets, and often in between. These are candid, probing discussions. Our standards for director independence more than meet those of the New York Stock Exchange.

I want to assure you that we will use this experience, and what we learn from the OFHEO Report and the Rudman review, to enhance our practices in these areas.

Conclusion

I believe in this Company that Congress created and in its mission. It is a privilege to serve on its Board. I cannot state strongly enough the Board's belief that Fannie Mae must meet the highest standards of openness, integrity, accountability, and responsibility. The role that Congress assigned in chartering this Company to expand affordable housing and homeownership in America remains absolutely critical as the nation and its housing needs continue to grow.

I believe a thorough and objective review of the facts on the issues in the OFHEO Report is the surest means to resolve this matter. I assure the members of this Subcommittee, the Congress as a whole, our regulators, our shareholders, investors and homebuyers, in other words the public, that we take these matters seriously and will move forward expeditiously.

Thank you.

EMBARGOED UNTIL:
10 am OCTOBER 6, 2004

Testimony by
Franklin D. Raines, Chairman and CEO, Fannie Mae
Before the House Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
October 6, 2004

Thank you, Chairman Oxley, Ranking Member Frank, Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee.

My name is Frank Raines, and I am Chairman and Chief Executive Officer of Fannie Mae. I greatly appreciate the opportunity to appear here today to answer your questions about issues raised in the September 2004 report by OFHEO of its special examination of Fannie Mae.

I would like to begin by noting that this is the first opportunity that Fannie Mae and its Board are taking to respond in an official forum to the allegations set forth in the OFHEO exam report.

We take this report seriously. Out of respect for the regulatory process – and for OFHEO – we have sought, with great diligence, to follow an orderly process throughout the special examination, which is ongoing. We have chosen not to respond *ad hoc* to questions about the exam report's content or conclusions. Instead, we will provide our responses in the appropriate forums, including through the Board's independent review, to the Securities and Exchange Commission, and to the Congress. I appreciate that the Committee has provided this forum today.

Some people have mistakenly concluded that the company's agreement with OFHEO constituted an admission by the company to the findings and conclusions of the report. Let me clarify that is not the case. The agreement itself states that the Company was not admitting or denying any wrongdoing as a result of signing the agreement.

Fannie Mae respects the role of OFHEO as our safety and soundness regulator. The strong oversight OFHEO provides is critical, given Fannie Mae's significant role in the U.S. housing finance system and the financial system as a whole. In our view, from a decade of experience working with OFHEO, I believe our safety and soundness regime makes Fannie Mae a better company. OFHEO has more examiners per regulated company than bank regulators do. OFHEO's risk-based capital standard is a model for financial institutions globally, and goes farther than new risk-based capital models being proposed for financial institutions with more complex operations than Fannie Mae.

The best financial institutions will tell you the same thing: they welcome the examination process because it fosters cooperation in making the institution the best that it can be. A confidential and cooperative examination process builds confidence – both the regulator's confidence in the company, but also the company's confidence in its own safety and soundness.

While this special examination departed from standard financial institution examination procedures, our obligation remains the same: to make adjustments needed to respond to OFHEO's concerns just as any financial institution would do with respect to its regulator.

That is why the company, led by our Board, promptly entered into a regulatory agreement with Director Falcon. There were three reasons that it was important to do so.

First, it was important to make it clear that the company sincerely wanted to address any issues our regulator might have that related to the safety and soundness of the company.

Second, it was important to respond quickly to as many of the issues presented by OFHEO as possible, and to establish a process to resolve the remaining issues.

Third, the agreement also recognizes the importance to the marketplace of putting in place an orderly process to move forward.

In particular, Fannie Mae has agreed to several measures:

- We will build up to a 30 percent capital surplus over the next 270 days.

- We will appoint a Chief Risk Officer, who will be independent of other corporate responsibilities and have duties crafted in consultation with OFHEO.

- The Board will hire an independent counsel and independent accounting consultant to review our accounting policies and practices and then report back to the Board and to OFHEO. And the Board will direct and oversee changes based on that review.

- We are making two changes to our accounting going forward. With respect to FAS 91, we will discontinue in the fourth quarter 2004 the use of a range to which OFHEO has objected. With respect to FAS 133, we will shift in the first quarter to the "long haul" approach where applicable to evaluating hedge effectiveness.

- We will separate our economic modeling and accounting functions.

- And we will separate our business planning and forecasting functions from the Controller's function.

Going forward, Fannie Mae's management is committed to working with OFHEO and our Board of Directors to comply with and carry out the terms of the agreement.

Let me thank our Board members, particularly our presiding director, Ann Korologos, for their dedication and efforts on behalf of Fannie Mae in the past 16 days. Their diligence made it possible to quickly set forth an orderly process to resolve the concerns raised by the OFHEO report.

In conjunction with the agreement, the Board's independent review committee has hired the law firm of Paul, Weiss, Rifkind, Wharton & Garrison to conduct an independent investigation, led by former Senator Warren Rudman, of the allegations in the special examination report. The issue of whether our implementation of FAS 91 and FAS 133 was consistent with Generally Accepted Accounting Principles (GAAP) remains with the SEC.

This agreement and these measures are important steps toward addressing the matters raised in the OFHEO report, and a way to move forward. Adopting these measures will make Fannie Mae stronger and even better able to pursue our mission and the business that fuels our mission.

That mission, after all, is our central function. Congress chartered Fannie Mae to expand access to homeownership for low- and moderate-income Americans. And we are committed to that mission. Earlier this year we announced a commitment to create six million first-time homebuyers – including 1.8 million minority first-time homebuyers – over the next decade, and do our part to raise the minority homeownership rate to 55 percent. By quickly reaching agreement with OFHEO where we could, we are able to maintain our mission focus.

For those that may be concerned that some of these steps, particularly the 30 percent capital surcharge, will constrain our mission activities, let me say this: Fannie Mae will do everything in our power to meet our commitments to expanding homeownership and affordable housing while also meeting the requirements of the agreement.

I would like to address the issues raised by the OFHEO report concerning our implementation of the accounting standards FAS 133 and FAS 91. These accounting standards are highly complex and require determinations over which experts often disagree.

I want to be clear that, in an effort to understand OFHEO's concerns and to prepare for today's hearing, I have made efforts to understand the facts related to the issues discussed in the OFHEO report, some of which involve highly detailed issues that I would not normally focus on in my role as CEO. My comments today will therefore include a combination of my own recollections and the facts about these issues that I have learned recently.

As to the two major allegations in the report, first, the report alleges that in 1998, the company willfully violated GAAP in order to maximize executive bonuses. This is a serious allegation, and we strongly disagree with it.

Second, the report alleges that we misapplied GAAP with respect to the two accounting standards, FAS 91 and FAS 133. We believe we applied those standards in accordance with GAAP, and our independent auditor, KPMG, reviewed our application of those standards and concurred.

Fannie Mae has previously issued and filed with the SEC financial statements that reflect the accounting and financial statement presentation that OFHEO has alleged to be inappropriate. Those financial statements were certified by me and by our Chief Financial Officer, Tim Howard, after a thorough process, and audited by our independent auditor, KPMG.

Fannie Mae has not withdrawn those financial statements and KPMG has not withdrawn its opinion that those financial statements were prepared consistent with GAAP in all material respects. Rather, the issues that have been raised by OFHEO will be taken up directly with the staff of the SEC, which ultimately has the final authority over GAAP.

FAS 133, the standard for derivative and hedge accounting, is considered one of the most complicated accounting standards ever issued. Parties, including Fannie Mae, submitted over 300 comment letters when it was first proposed in 1996, and it took five years to complete. To deal with the complex interpretations it requires, the Financial Accounting Standards Board, or FASB, formed a Derivatives Implementation Group, which has issued over 170 interpretive rulings. The standard and its implementation guidance fill over 900 pages.

There is no dispute that Fannie Mae uses derivatives for one reason: that is to reduce risk through hedging. Unlike many other major investors, Fannie Mae does not make money by speculating or trading in derivatives. We purchase derivatives – from major established financial firms – to help us reduce the interest rate risk that is inherent in financing long-term, fixed-rate mortgages in a floating rate economy. We use derivatives in the way Federal Reserve Board Chairman Alan Greenspan has said is healthy for the financial system – to help reduce risk.

Given the complexities of FAS 133, from the beginning, Fannie Mae's approach to adopting the standard was careful, considered, and thorough.

We spent three years preparing to implement FAS 133 before it was adopted in 2001. We worked closely with FASB to ensure it understood how Fannie Mae uses derivatives, and to ensure Fannie Mae understood the FASB's approach. Then, when FASB adopted the standard, Fannie Mae put together a multi-disciplined task force to work on its implementation.

Before we implemented FAS 133, our independent auditor, KPMG, reviewed both our detailed policy and the operational processes and systems that we developed to apply the policy. We then ran our FAS 133 processes and systems in parallel with the existing accounting for the year before FAS 133 became effective to ensure that everything was operating properly.

Finally, KPMG re-reviewed our policies on two different occasions – once when Fannie Mae revised its hedge guidelines in 2003, and again in 2004.

I believe that we have tried hard to apply FAS 133 the right way, and that the transactions in question were eligible for hedge accounting. OFHEO has stated otherwise. We look forward to a determination by the SEC.

As for FAS 91, this standard requires that premiums we pay, or discounts we receive, on the purchase of mortgage backed securities be amortized over the expected average life of the security. Since homeowners often prepay mortgages and refinance when interest rates fall, we determine the period of amortization using two estimates. First, we estimate future interest rate changes. Second, we estimate prepayments – that is, how homeowners will react to interest rate changes.

As these estimates change, so does the expected average life of the mortgage. Therefore, under FAS 91 the amount of amortization that must be booked as income or expense changes in any given period.

Given these imprecisions, Fannie Mae decided to use a range of possible outcomes for our FAS 91 amortization. KPMG reviewed our FAS 91 policy when it was implemented in 2000.

Our internal accounting experts believed that using a range was consistent with GAAP. In preparing our financial reports, as recently as last quarter's SEC Form 10-Q, KPMG told us they concurred with our use of a range.

As is the case with FAS 133, the SEC will ultimately decide whether our policy was, or was not, consistent with GAAP. We have agreed with OFHEO to discontinue the use of a range in implementing FAS 91 beginning in the fourth quarter of 2004.

Our accounting staff has repeatedly determined that our policies and practices with regard to FAS 91 and 133 are reasonable and in accord with GAAP and KPMG has issued unqualified opinions on our financial statements. That remains their position today. Our purpose in describing our approach to these standards is not to argue that we are right and OFHEO is wrong. What we want to demonstrate is that we intended to do the right thing and we took care to do the right thing.

In fact, when I certify our financial statements, I certify that these documents "fairly present in all material respects the financial condition, results of operations and cash flows" of the company. That is a very serious statement, and I take it very seriously.

We engage in a rigorous due diligence process before I ever put a pen to paper and make that certification.

First, our draft financial reports are reviewed by dozens of people, including key businesspersons. Each senior businessperson must formally sign off on each report.

Next, our Disclosure Committee, made up of seven senior officers including the Controller, the General Counsel and the head of internal audit, reviews drafts of the report and meets to discuss the draft. The Disclosure Committee represents to the CFO and the CEO that the report is accurate and controls around disclosures are effective.

In addition, over 30 officers provide representation that they have disclosed to the head of internal audit any issues in their areas that could be material to the financial statements or internal controls.

At this point, I engage in a rigorous due diligence session with our controller, our head of internal audit, our general counsel, chief operating officer, and chief financial officer, attended by KPMG, where I receive reports about the financial statements, accounting policy developments, key disclosures, and any internal control considerations. The CFO and I ensure that any questions raised during this session are answered prior to finalizing the report.

Then the Board's Audit Committee reviews the draft report, and holds a conference call with senior management, and attended by KPMG, to discuss the report and results of our due diligence session. And of course, KPMG provides its opinion on the financials.

I only certify after receiving assurance that I can say with confidence that our financial statements "fairly present in all material respects the financial condition, results of operations and cash flows" of the company.

Conclusion

Mr. Chairman, no one is more interested in a full and open examination of these issues than I am.

I cherish this company. I believe in the mission that Congress challenged Fannie Mae to carry out. And I am inspired by the 5,000 women and men who come to work every day trying to help lenders help people get into homes.

Most of all, I believe Fannie Mae's biggest challenge ahead is helping the financial system and mortgage industry to meet the growing and changing housing needs of our growing and changing nation. This decade is expected to produce 30 million more Americans who will create 13-15 million new households. Minorities will represent 80 percent of the growth. As a result, we estimate that 46 percent of future first-time homebuyers will be minorities and immigrants. Serving their housing needs

will require new ideas and innovations in mortgage financing, and we look forward to helping the industry with this challenge.

Given this public mission for which Congress created us, and as an instrument of national housing policy, Fannie Mae expects and welcomes OFHEO's rigorous oversight to ensure that we are safe, sound, solid and stable for the long run. As I said the last time I appeared before this Committee, strong oversight is in the best interest of Fannie Mae, our shareholders, financial markets, and homeowners.

Thank you, Mr. Chairman and members of the Committee. I look forward to answering any questions you may have.

U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

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BERNARD SANDERS, VT

November 4, 2003

The Honorable Armando Falcon, Jr.
Director
Office of Federal Housing Enterprise Oversight
1700 G Street, NW
4th Floor
Washington, DC 20552

Dear Director Falcon:

Pursuant to its authority and responsibility under rules X and XI of the Rules of the House of Representatives for the 108th Congress, and rule 5(a)(1)(A) of the Rules of the Committee on Financial Services for the 108th Congress, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises is continuing its oversight of Fannie Mae and Freddie Mac.

In your letter of July 9, 2003, you delineated the officials at Fannie Mae and Freddie Mac for whom OFHEO reserves the right to review and disapprove of compensation and termination benefits. Please provide the Subcommittee with information describing the compensation package for each position referenced in your letter. That information should include, but not be limited to: (1) the amount of annual salary and fringe benefits; (2) amounts of deferred compensation; (3) corporate retirement contributions; (4) insurance benefits; (5) private club memberships; and (6) stock options.

I would appreciate your response to this request not later than November 7, 2003, and look forward to your reply.

Yours truly,

Richard H. Baker

Richard H. Baker
Chairman
Subcommittee on Capital Markets,
Insurance, and Government Sponsored
Enterprises

RHB/hnh

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

November 12, 2003

The Honorable Richard Baker
Chairman
Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives
341 Cannon House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Per your request of November 4, 2003, I am providing the attached information regarding executive compensation of "covered individuals" at Fannie Mae and Freddie Mac. Please note that the information not provided in proxy statements is non-public information.

Please contact me if there is any question about these materials or matters related to your request.

Sincerely,

Armando Falcon, Jr.
Director

Attachment

Fannie Mae 2002 Executive Officer Compensation (December 31, 2002)

Executive Officer	Salary	2002 Bonus (Paid in 2003)	Fringe Benefits/ Other Annual Comp.	Corporate Contributions to Retirement: 401 (k)/ESOP	Life Insurance: Death Benefit/ Value	Long Term Compensation: Performance Shares(PSP)/ Restricted Stock (PSP not eligible for payment before 2006-2007)	Private Club Payments	Stock Option Awards #/ Grant Date Present Value	Total Compensation (see note)
Frank Raines	$992,250	$3,300,000	$79,667	$6,000 (401k)	$3,087,912/$17,723	$6,680,345 (PSP)	$7,200	311,731/$6,680,395	$17,732,657
Daniel Mudd	$689,250	$911,250	$2,333	$6,000 (401k)	$1,378,500/$2,594	$1,776,951 (PSP)	$5,020	82,918/$1,776,933	$ 5,156,717
Timothy Howard	$498,750	$498,750	$2,144	$6,000 (401k)	$594,568/$5,238	$1,749,982 (PSP)	-0-	81,661/$1,749,995	$ 4,499,621
Robert Levin	$480,183	$575,000	$1,925	$6,000 (401k)	$559,592/$2,836	$1,552,502 (PSP)	-0-	72,445/$1,552,496	$ 4,162,106
Thomas Donilon	$428,400	$600,000	$1,965	$6,000 (401k)	$428,400/$278	$1,619,986 (PSP)	-0-	75,595/$1,620,001	$ 4,270,352
Julie St. John	$428,400	$570,000	$2,039	$6,000 (401k)	$428,400/$373	$1,368,009 (PSP)	-0-	63,836/$1,368,005	$ 3,736,453
Michael Williams	$428,400	$570,000	$1,840	$6,000 (401k)	$428,400/244	$1,368,009	-0-	63,836/$1,368,005	$ 3,736,254
Louis Hoyes	$428,400	$500,000	$2,104	$6,000 (401k)	$428,400/$454	$1,349,988 (PSP)	-0-	62,996/$1,350,004	$ 3,630,496
Adolfo Marzol	$441,769	$400,000	$1,840	$6,000 (401k)	$454,391/$214	$1,079,991 (PSP)	-0-	50,397/$1,080,008	$ 3,003,608
Peter Niculescu	$425,000	$350,000	$1,811	$6,000 (401k); $4,000 ESOP	$346,421/$173	$969,009 (PSP)	-0-	52,505/$1,107,691	$ 2,853,511
Ann Kappler	$290,900	$525,000	$1,669	$6,000 (401k); $4,000 ESOP	$270,000/$154	$682,482 (PSP)	-0-	31,488/$682,503	$ 2,182,554
Gallo, Kathy	$260,000	$275,000	$82	$4,000 ESOP	$260,000/$130	$766,750 (PSP)	-0-	32,296/$742,731	$ 2,044,563
Ann Kappler	$290,900	$525,000	$1,669	$6,000 (401k); $4,000 ESOP	$270,000/$154	$682,482 (PSP)	-0-	31,488/$682,503	$ 2,182,554
Linda Knight	$330,000	$385,000	$1,873	$6,000 (401k); $4,000 ESOP	$318,707/$290	$625,624 (PSP)	-0-	29,124/$625,627	$ 1,968,124
Kenneth Bacon	$306,200	$420,000	$1,810	$6,000 (401k); $4,000 ESOP	$329,835/$234	$546,023 (PSP)	-0-	25,458/$545,994	$ 1,820,027
Michael Quinn	$329,100	$474,375	$1,855	$6,000 (401k); $4,000 ESOP	$373,061/$265	$455,423 (PSP)	-0-	21,251/$455,409	$ 1,716,162
Arne Christensen	$239,500	$300,000	$1,656	$6,000 (401k); $4,000 ESOP	$233,047/$103	$337,482 (PSP) $305,492 (R. stock)	-0-	15,749/$337,501	$ 1,521,631
Thomas Lawler	$350,000	$315,000	$1,887	$6,000 (401k); $4,000 ESOP	$360,907$278	$409,502 (PSP)	-0-	19,109/$409,506	$ 1,485,895
Thomas Lund	$266,000	$317,075	$1,660	$6,000 (401k); $4,000 ESOP	$256,225/$138	$390,363 (PSP)	$4,650	18,217/$390,390	$ 1,365,488
Leanne Spencer	$260,000	$330,000	$1,692	$6,000 (401k); $4,000 ESOP	$245,644/$160	$396,017 (PSP)	-0-	18,479/$396,005	$ 1,383,714
Andrew McCormick	$216,000	$309,375	$1,633	$6,000 (401k); $4,000 ESOP	$199,864/$94	$379,488 (PSP)	-0-	$17,709/$379,504	$ 1,286,000
Duane Duncan	$220,000	$212,500	$1,642	$6,000 (401k); $4,000 ESOP	$189,108/$79	$213,761 (PSP)	$1,224	13,048/$272,241	$ 920,144
Vada Hill	$285,000	$237,500	$1,757	6,000 (401k); $4,000 ESOP	$314,928/$157	$195,927 (PSP)	-0-	9,143/$195,395	$ 915, 378

Notes to Fannie Mae Table

Executive Officer: Officers in shaded areas (Raines, Mudd, Howard, Levin) are listed in 2002 proxy statement. Former Vice-Chair Jamie Gorelick was the fifth officer listed in the proxy. That position no longer exists at Fannie Mae and accordingly is not among the 22 covered executive officer positions.

Salary: Salary shown is the salary rate as of December 31, 2002. Any deferrals are included in the value shown.

Bonus: Bonus shown is the amount paid in February 2003 for the 2002 performance year. Any deferrals are included in the value shown.

Fringe Benefits/Other Annual Compensation: Value of fringe benefits is amount shown in proxy statement, minus value of 401(k) and life insurance (reported separately.

Corporate contributions to retirement: Shows Fannie Mae contribution to an executive's 401(k) plan and ESOP. Fannie Mae's other retirement plans are defined benefit plans and the company's contributions are made for all plan participants in the aggregate. Because these are not individual account plans, the contributions are not allocated on an individual basis.

Life Insurance/ Value: For Raines, Mudd, Howard and Levin, value of life insurance calculated by SEC "demand loan" method. For the other executives, figure reflects the amount included on the executive's W-2 statement as imputed income on the value of the life insurance policy.

Private Club Payments: The total cost of private club payments is allocated between personal and business use based on the percentage of total use that is personal or business use. For 2003, the private club payments are as follows: Franklin Raines $9,650; Thomas Lund $5,000; Duane Duncan $1,188; Daniel Mudd $85,345. Fannie Mae indicates that $80,000 of the private club payments for Mr. Mudd in 2003 was a one-time initiation fee provided for Mr. Mudd as part of his offer package.

Total Compensation: For purposes of this chart, total compensation equals the sum of salary, bonus, fringe benefits, long-term compensation, private club payments and stock option awards. Excluded from total compensation are contributions to corporate retirement (401(k)/ESOP) and life insurance (death benefit/value)

Freddie Mac 2002 Executive Officer Compensation (December 31, 2002)

Executive Officer	Salary	2002 Bonus	Fringe Benefits/ Other Annual Comp.	Corporate Contributions to Retirement	Life Insurance: Death Benefit/ Value	Long Term Compensation: Restricted Stock: Dollar Value	Private Club Payments	Stock Option Awards #/ Grant Date Present Value	Total Compensation (see note)
Leland Brendsel	$1,173,333	-0-	$88,895	$295,809	$1,000,0000/$66,838	$5,821,647	-0-	193,040/$4,720,407	$11,804,202
David Glenn	$870,833	-0-	$42,968	$179,952	$1,000,000/$35,038	$3,466,201	-0-	114,930/$2,810,039	$ 7,190,041
Paul Peterson	$445,833	-0-	$5,835	$105,153	$1,000,000/$20,312	$340,217	-0-	20,940/$511,983	$ 1,303,868
Bill Ledman	$427,500	-0-	$2,174	$64,879	$860,000/$19,978	$278,770	-0-	17,150/$419,369	$ 1,127,813
Greg Parseghian	$1,000,000	-0-	$1,140	$143,392	$1,000,000/$39,530	-0-	-0-	-0-	$ 1,001,140
R. Mitch Delk	$455,000	-0-	$1,710	$75,376	$1,000,000/$19,672	$247,724	$7,525	15,320/$374,620	$ 1,086,579
Maud Mater	$387,167	-0-	$7,152	$79,878	$1,000,000/$27,929	$252,899	-0-	15,560/$380,489	$ 1,027,707
Vaughn Clarke	$382,500	-0-	$3,724	$55,339	$385,000/$10,075	$191,453	-0-	11,780/$288,021	$ 865,698
David Andrukonis	$348,654	-0-	$2,210	$61,081	$1,000,000/$19,539	$189,512	-0-	11,640 / $284,633	$ 825,009
Mel Kann	$302,500	-0-	$3,158	$46,250	$304,000/$17,583	$164,287	-0-	10,110/$247,220	$ 717,165
Adrian Corbiere	$357,000	-0-	$3,333	$37,267	$720,000/$13,252	$140,356	-0-	8,620/$210,785	$ 711,474
Pete Maselli	$300,000	-0-	$3,530	$57,433	$900,000/$13,519	$149,411	-0-	9180/$224,479	$ 677,420
Edmond Sannini	$275,000	-0-	$1,395	$1,375	$825,000/$8008	$137,122	-0-	8,410/$205,650	$ 619,167
Robert Tsien	$260,000	-0-	$1,871	$21,411	$520,000/$6,985	$112,543	-0-	6,920/$169,215	$ 543,629
Dwight Robinson	$269,167	-0-	$3,611	$34,626	$813,000/$12,628	$99,607	-0-	6,130/$149,897	$ 522,282
Margaret Colon	$209,500	-0-	$1,211	$44,943	$795,000/$11,405	$97,657	-0-	6,000/$146,718	$ 455,086
Don Bisenius	$227,250	-0-	$756	$35,059	$687,000/$10,293	$89,258	-0-	5,480/$134,002	$ 451,266
Dave Stevens	$290,000	-0-	$4,738	$40,838	$290,000/$7,881	$56,918	$5,500	3,480/$85,096	$ 442,552
Rob Dean	$217,875	-0-	$723	$25,952	$660,000/$5,826	$76,322	-0-	4,680/$114,440	$ 409,360
Michael Hager	$300,000	-0-	$8,290	$3,000	$300,000/$11,950	-0-	-0-	-0-	$ 308,290

Notes to Freddie Mac Table

Executive Officer: Freddie Mac did not file a proxy statement in 2002. Officers listed in shaded areas (Brendsel, Glenn, Peterson, Ledman, Parseghian) are listed in the 2001 proxy statement.

Salary: Any deferrals are included in the value shown.

Bonus: Freddie Mac has not yet awarded 2002 bonuses to senior officers, pending completion of restatement.

Fringe Benefits/Other Annual Comp: Total of group term life, fringe gross up, financial counsel (and special insurance premium and Supplemental Term Life Insurance that applied only to Mr. Brendsel and Mr. Glenn).

Life Insurance/Value: Benefit amount/premiums paid.

Private Club Payment: This data represents annual membership dues and other miscellaneous annual fees associated with private club membership. Mr. Stevens was one of Freddie Mac's October 2002 through 2003 designated members at a private club, a status which enabled use of the club by other Freddie Mac employees. Freddie Mac indicates that personal use is possible under the terms of the membership but is not aware of instances in which the membership has been used for anything other than a business purpose. Annual dues were paid on January 9, 2003. Mr. Delk uses his private club membership for business purposes only. For 2003, the private club payment for Mr. Delk was $9,675.

Total Compensation: For purposes of this chart, total compensation equals the sum of salary, bonus, fringe benefits, long-term compensation, private club payments and stock option awards. Excluded from total compensation are contributions to corporate retirement (401(k)/ESOP) and life insurance (death benefit/value)

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DELAWARE, AT-LARGE

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October 5, 2004

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Dear Chairman Herz:

As the independent body charged with establishing and improving standards of financial accounting and reporting for issuers, auditors and users of financial information, I would like to seek your comment on the recent accounting issues that have arisen as a result of the Office of Federal Housing Enterprise Oversight's (OFHEO) special examination of the Federal National Mortgage Association (Fannie Mae).

Specifically, OFHEO's report finds fault with the company's accounting treatment of (1) the amortization of premiums, discounts, and fees related to the purchase of mortgages and mortgage-backed assets [under Statement of Financial Accounting Standards (SFAS) 91], and (2) financial derivative contracts (under SFAS 133).

KPMG LLP, Fannie Mae's auditor has stated it "stands behind" its audit work. Fannie Mae has also stated they believe they were following Generally Accepted Accounting Principles (GAAP). In February 2004, OFEHO hired Deloitte and Touche LLP to examine the accounting policies at Fannie Mae.

I am concerned that two different auditors would have different interpretations of SFAS 91 and SFAS 133. I would appreciate your comments on whether Fannie Mae's accounting practices, as described by OFHEO, are in compliance with the relevant FASB standards.

According to OFHEO, Fannie Mae since 1998 has deferred recognition of significant amounts of income related to the amortization of price adjustments, amounts referred to as the "catch-up" position. OFHEO finds evidence that Fannie Mae "specifically intended to manage the catch-up position as a buffer to sudden changes in interest rates and the resultant volatility of amortization accounts." In other words, Fannie Mae adopted policies "designed to provide earnings flexibility and minimize earnings volatility." Can such policies be considered compliant with SFAS 91?

Furthermore, OFHEO concludes that, with regard to several derivatives transactions, Fannie Mae failed to test the effectiveness of hedged positions treated as cash flow or fair value hedges and, instead, simply assumed that the hedges were perfectly effective. Does this accounting policy comply with SFAS 133?

As the independent body charged with establishing financial accounting standards, I would appreciate your comments on SFAS 91 and 133 and whether these standards need to be readdressed to remove gray areas that have resulted in misinterpretations.

I appreciate your attention to this matter and look forward to receiving your comments.

Sincerely,

Mike Castle

Michael N. Castle
Member of Congress

MNC:epp

Merrill Lynch

FIXED INCOME STRATEGY

27 September 2004

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Agencies

Déjà Vu All Over Again

Thoughts on OFHEO's Special Examination of FNM

Highlights

- OFHEO's 211 page report provides little quantification as to the scope and magnitude of FNM's alleged violations of GAAP, but offers a harsh assessment of the firm's internal controls, policies, procedures, and corporate culture.
- Longer term, the report and any potential regulatory changes are debt-holder friendly events, but near term, expect elevated levels of headline risk, uncertainty, and spread volatility.
- In our view, many of the issues highlighted by OFHEO as "misapplications" of GAAP may very well end up being adjudged as differences in accounting interpretations between auditors.
- The SEC will be the ultimate arbiter of the SFAS91 and SFAS133 related issues raised by OFHEO. We are also keen to hear the views of the independent counsel retained by FNM's Board.
- It appears unlikely that there will be a quick resolution to this controversy, but OFHEO, a regulator that has been criticized in the past, now seems to be more aggressive and interested in effectuating a change in corporate culture at FNM by targeting senior management.
- Is FNM's predicament as bad as FRE's restatement last year? While our read of OFHEO's report certainly doesn't indicate that FNMs alleged transgressions are of the same magnitude as those relating to the FRE transactions, there is one important distinction. For all its maneuvers, FRE had a surfeit of capital that it was trying to defer. In FNM's case, while impossible to quantify based on the information available, in our view, the direction of any potential restatement is more likely to erode the current capital base.
- Depending on the outcome of the SFAS133 related allegations, there is a very small but finite possibility that, at least historically, FNM's core capital level may have fallen below its required minimum capital threshold. We emphasize though that shifting the timing of any derivative related losses has only an accounting impact at this juncture, not an economic one.
- We do not believe FNM's safety and soundness is at stake, and even in a worst case scenario, as long as no major business restrictions are placed on the firm, it should be able to take remedial actions from a capital perspective, in our view.
- OFHEO's report will certainly provide GSE critics with more fodder to continue pressing for higher capital standards and tougher regulation.

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Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 7. Analyst Certification on page 6.

- **The Facts**

- Late last week, the Office of Federal Housing and Enterprise Oversight (OFHEO) released a harshly worded report on Fannie Mae's (FNM) accounting practices.
- In it, the GSE regulator casts doubt on the "*validity of previously reported financial results, the adequacy of regulatory capital, the quality of management supervision, and the overall safety and soundness of the Enterprise.*"
- The tone of the 200-plus page report is harsh, and OFHEO goes to great technical lengths to highlight what it considers as intentional violations of Generally Accepted Accounting Principles (GAAP) by FNM.
- In particular, OFHEO alleges that Fannie Mae "misapplied" certain critical accounting standards (SFAS 91, in relation to premium amortization and SFAS 133 in relation to derivative accounting), purely with the intent of smoothing out reported earnings. Our equity analyst, Mike Hughes, provides more details on the accounting issues involved and offers his thoughts on the matter in his report, "*THE OFHEO Report: A Scathing Tome*", September 23.
- In the report, OFHEO depicts a picture of FNM as a corporate culture obsessed with portraying the firm as a "*consistent generator of stable and growing earnings*". In addition, the regulator alleges a host of corporate governance issues, such as "*an operating environment with weak or non-existent controls, key person dependencies and poor segregation of duties, a dysfunctional process for developing accounting policies, and an inordinate concentration of responsibility vested with the Chief Financial Officer.*"
- Subsequent to the release of the report, OFHEO injected even more uncertainty into an already uneasy marketplace, as a spokesman was quoted saying that Fannie's accounting problems are "*more serious than Freddie's*". (Those that follow the Agency market will undoubtedly recall Freddie Mac's accounting problems revealed last summer, which led to management turnover, and intensified calls for serious GSE regulatory reform legislation.)
- OFHEO Director Armando Falcon also sent a letter to FNM's Board stating, "*we must consider the accountability of management and whether we have sufficient confidence in management to fully implement these corrective measures ...the findings of this report make it difficult to assert such confidence*"
- In light of these developments, Standard and Poor's put FNM's subordinated debt and preferred stock credit ratings on "CreditWatch Negative", stating that the AA- ratings would either be lowered a notch or affirmed pending resolution of the issues raised by the OFHEO's report.
- However, the rating Agency reaffirmed the AAA ratings on the senior unsecured debt, stating that "*even if the ratings on the sub-debt are lowered, the AAA ratings on the senior debt will not be adversely affected, since there has been no change to the policy framework and the related links to the government*"
- Through all the headlines, Fannie Mae and its auditor (KPMG) have maintained radio silence, apart from the statement made by the Board that it is taking OFHEO's findings "*very seriously*".

- It is worth noting that the Board's Audit Committee (which is overseeing the company's response to OFHEO's examination) was very proactive, engaging outside counsel within a few weeks of the onset of OFHEO's investigation, almost eight months ago. In turn, outside counsel retained the accounting firm, Ernst and Young, to help in its independent investigation. Given how long the Board has already been reviewing the issues under consideration, it may be in a position to comment on OFHEO's charges relatively soon.

Our Take on OFHEO's Report

- While OFHEO goes to great lengths to point out deficiencies in corporate governance, and attacks accounting process and policy formulation, **nowhere in the report does OFHEO quantify the likely financial or economic impact of its findings**.
- **In fact, OFHEO has not even been able to definitively conclude whether a financial restatement is necessary**.
- **Early last week a spokesman for KPMG (Fannie Mae's auditor) was quoted as saying that the firm continues to stand by its work.** It is apparent in the report that FNM seems to have consulted its auditors extensively in developing its accounting policies and practices.
- **As a result, it is possible that some of the issues raised by OFHEO may end up being explained as differences in interpretation of accounting standards between two auditors.** The SEC will be the ultimate arbiter in the discussions that appear to be in store in coming months.
- **While FNM's Board has not yet commented on the status of its independent investigation, it is notable that despite seven or eight months of review, it has not made changes in current management.** Recall that last year, FRE's Board quickly ousted management based on the review conducted by outside counsel.
- While the markets have been put on notice by OFHEO, it appears that most observers are awaiting comment from the SEC and from FNM's Board before passing judgement. We note that FNM has been a SEC registrant since 2003, and despite OFHEO's concerns, the status of the SEC's inquiry currently remains "informal".

SFAS91 Issues Will Probably Not Have Material Economic Impact

- Even if the alleged violations of SFAS 91 (which are covered in the first 81 pages of OFHEO's report), are proven true, it is not clear that it will end up causing a material economic impact on FNM's historical results.
- What may end up being more important relating to SFAS91 issues, in our view, regardless of materiality, is if the allegations about managing earnings purely to trigger executive bonuses in 1998, are borne out to be true. This certainly has the potential to create management turnover. We believe that OFHEO wants to effectuate a change in corporate culture at FNM.

Why Is OFHEO Raising "Safety and Soundness" Concerns? : In A Worst Case Scenario, SFAS133 "Losses" Could Be Sizeable

- Given the size of FNM's derivatives book and the SFAS 133 issues raised by OFHEO, ***if its arguments prevail***, have the potential, in a worst case scenario, to be material from an accounting and regulatory capital perspective, although not necessarily from an economic perspective. Welcome to the complex world of hedge accounting.

- SFAS133, which was issued in 1998 and became effective in 2001, is widely considered to be one of the most nebulous accounting standards in GAAP. As background, (grossly simplifying matters) keep in mind that as per SFAS133, if a derivative qualifies as a "cash flow hedge", market value fluctuations are recorded in the Accumulated Other Comprehensive Income (AOCI) account on the balance sheet, with any losses recognized into net income over time. However, if a derivative does not qualify as a cash flow hedge, market value fluctuations must be recorded into net income immediately.
- The notional amount of FNM's derivative book as of 06/30/04 was roughly $1 trillion, and almost 80% of that was designated as a cash flow hedge, thereby qualifying for the accounting treatment outlined above.
- OFHEO claims that FNM failed the extensive documentation and effectiveness testing requirements necessary to claim hedge accounting for the bulk of its derivatives. As a result, OFHEO contends FNM should have been recognizing derivative market value fluctuations into net income immediately.
- Now, given that KPMG signed off on FNM's derivatives accounting policy, we expect a vigorous debate on the appropriateness of FNM's derivative accounting methodology.
- However, we note that FRE (that is still going through its own restatement process) now designates only about 10% of its $1.2 trillion derivative book as a cash flow hedge. In our view, this treatment may have been chosen after consultation with OFHEO and possibly even the SEC.
- As a result, there may be a strong possibility that FNM may be required to reverse its current cash flow hedge designation for the bulk of its derivatives, at least prospectively.
- Even if OFHEO's view prevails, based on the information available in the report, it is impossible to determine what the portion of the AOCI losses currently on the balance sheet will have to be recognized into net income immediately. OFHEO has stated that it does not have a full handle on this yet.
- So why, then, is the regulator raising potential "safety and soundness concerns"? Consider a worst-case scenario as of 06/30/04 if OFHEO's arguments prevail. As of that date, the AOCI balance attributable to cash flow hedges was roughly $(8.2) Bn.
- While this figure may seem extraordinarily large, recall that FNM's cashflow hedges are primarily comprised of pay-fixed swaps, caps, and swaptions that are in effect used to create synthetic fixed rate debt. The market-value of these derivatives (just like that of straight fixed-rate debt) is highly correlated with interest rates -- when rates fall, these derivatives show losses, and when rates rise, they show gains.
- Note that if FNM had elected to issue straight debt in lieu of creating a synthetic equivalent, the economic impact on the firm would have been the same, but the accounting impact would be profoundly different. This is because the market value of straight debt (unlike its synthetic form) is not marked to market every quarter, and any market value fluctuations are not recognized into income. Herein lies the major criticism of SFAS133: two strategies that are economically equivalent can have significantly different accounting impact.

- As a worst case scenario, we believe that FNM may be forced to recognize the entire amount of AOCI losses associated with cash-flow hedges as of 06/30/04 (8.2Bn) into income.
- As of 06/30/04, FNM's core capital[1] was $36.1 Bn, roughly $4.9 Bn in excess of its required minimum capital threshold[2], and $20.0 Bn in excess of the "critical capital threshold.
- If the entire amount is recognized FNM's core capital may fall below its minimum requirements. If a smaller fraction of AOCI losses is recognized, FNM's capital cushion will be eroded, but may not fall below any regulatory thresholds.
- *However, applying OFHEO's preferred method of accounting historically may unearth periods of time when FNMs capital may have been technically in violation of its minimum requirements.*
- **What does this imply from an economic perspective at this juncture?** Not much, in our view. **From an economic perspective, note that it is inappropriate to count only the losses recorded on derivatives and ignore the gains embedded in FNM's portfolio.**
- For instance, as of 06/30/04 FNM had gains of around $1 Bn on its AFS securities. The AFS portion is only roughly a quarter of its total portfolio. While it is a stretch to extrapolate gains, assuming a similar coupon distribution on its HTM portfolio would imply the existence of a further $3B in unrecognized gains. So, a simple accounting recategoriztion of these assets would generate $4B in gains that could potentially offset over half the maximum AOCI losses in question. Recognition of a $4B loss (8Bn AOCI losses less $4Bn securities gains) would still leave FNM's core capital above its minimum requirements as of 06/30/04.
- Another way to assess the situation and get away from accounting distortions is to consider the fair value of equity[3], last reported on 12/31/03. As of that date, FNM's fair value of equity was $31.6 Bn, not too far removed from its reported core capital of $34.4 B, and slightly in excess of required minimum capital of $31.5 Bn.
- **Even if FNM is found to have been in technical violation of its minimum capital requirements, it does not indicate an imminent economic crisis, in our view.** To use an analogy any homeowner would relate to: if your home was accounted for using SFAS 133, you would be forced to record market value fluctuations in the price of your house into your net worth on a quarterly basis. Now, if the price of the house declined dramatically from one quarter to the next, it may make your LTV ratio (loan-to-value, or implied leverage) higher than you or your lender wants, but it doesn't necessarily have a bearing on whether you can pay your mortgage bill. Now if you also lost your job, eventually depending on your savings or capital cushion, you may experience financial distress.

[1] Core Capital=The sum of (a) Stated value of outstanding common stock (b) stated value of outstanding noncumulative perpetual preferred stock (c) paid-in-capital (d) retained earnings less treasury stock. Excludes AOCI.

[2] Minimum capital = The sum of (a) 2.5% of on-balance sheet assets; (b) 0.45% of outstanding MBS (c) 0.45% of other off-balance sheet obligations

[3] Using fair value of equity as a metric has its own set of limitations, but we defer a discussion of that topic for another day.

- Bottom-line on SFAS 133 Issues:

  Depending on the resolution of the allegations, there is a small but finite possibility that any potential restatement may be large enough to cause FNM's core capital levels to fall below its required minimum capital threshold, at least on a historical basis.

  We emphasize though that shifting the timing of recognition of any derivative related losses has only an accounting impact at this juncture, not an economic one.

  As long as no major business restrictions are placed on the firm, in our view, it should not face much difficulty in taking remedial actions from a capital perspective.

Impact on sub-debt

- Can any potential financial restatements trigger the interest deferral trigger on the subordinated debt? In our view, very unlikely.
- Recall that the only mandatory way in which the deferral feature is triggered is if core capital falls below 125% of "critical capital" levels[4]. In other words, as of 06/30, the core capital would have to decline by almost $16 Bn from current levels. There is virtually zero probability that even if a restatement were eventually deemed necessary, the cumulative hit to equity would come anywhere close to this magnitude.

Conclusions

- Expect the inflammatory headlines, political rhetoric, and uncertainty to continue for the next few months. Keep in mind, though, that to date we have heard only one side of the story.
- OFHEO's report will certainly provide GSE critics with more fodder to continue pressing for more disclosure, tougher regulation and higher capital standards. Longer term, these developments are a positive for debt-holders.
- Near term, while spreads have firmed from the wides seen on Thursday, we expect continued volatility, as more details become available.

Analyst Certification

I, Rajiv Setia, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

[4] Critical capital = The sum of (a) 1.25% of on-balance sheet assets; (b) 0.25% of outstanding MBS (c) 0.25% of other off-balance sheet obligations. Critical capital was $15.97Bn as of 06/30/04

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Written Testimony of Roger Barnes
Former Manager of Financial Accounting, Deferred
Assets in Fannie Mae's Controller Division

For the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing on "The OHFEO Report: Allegations of Accounting and Management Failure at Fannie Mae"

October 6, 2004

I wish to thank the members of the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises ("the Subcommittee") for providing me with the invitation and opportunity to submit this written testimony.* I use the word "opportunity" deliberately because this Committee is perhaps the only venue for me to speak out publicly about my personal experiences at Fannie Mae after I brought important issues of corporate impropriety to light. Likewise, I believe this statement is an important opportunity for the Members of this Subcommittee to learn about the corporate culture at Fannie Mae. Although Fannie Mae is a Company that receives accolades for providing a diverse and positive work environment, it is also plagued by a corporate culture that uses threats, intimidation, and reprisal, to create an atmosphere where even those employees with great integrity – employees who rightfully feel duty-bound to report improprieties and irregularities – cannot risk doing so, fearing the retaliation that they know will follow.

I suppose it would be easy for us to be satisfied with the Office of Federal Housing Enterprise Oversight's rigorous investigation of Fannie Mae's amortization and other accounting practices that do not comply with GAAP. Indeed, I commend OFHEO's examination as well as its ultimate conclusions. What the report does not address, however, is the punishment I and others like me have been subjected to by Fannie Mae management for calling attention to the very problems OFHEO investigated. I believe it to be my duty to tell the story of what happened to me when I spoke up so that this Subcommittee can better understand the necessity of acting to protect individuals at Fannie Mae, like myself, who step forward and speak up when they observe

* To the best of my recollection, the dates recounted herein are accurate. However, because the relevant documents are in Fannie Mae's possession, I have been unable to confirm these dates in drafting this testimony.

improprieties. Without such protections I fear that few people at Fannie Mae will report future irregularities or improprieties that they observe. And why should they? They observed that Fannie Mae promoted literally every employee who was involved in or assisted the effort to suppress the truth about the accounting and financial irregularities I reported, and which OFHEO confirmed. More importantly, they also watched while I was stripped of my duties, excluded from meetings, downgraded in my performance reviews, denied appropriate promotions, had my abilities denigrated and my motives questioned, and was ultimately forced from the Company.

Fannie Mae espouses a policy of adherence to good corporate governance, emphasizing the importance of integrity. The company professes to maintain policies to ensure proper and fair treatment of employees. The reality, however, is far different. I am telling my story today, fearing that I will suffer further retaliation as a result, because I believe that doing so is in the best interests of the investing public and the Company's current employees. The atmosphere and culture, particularly within the Controller's Division, is one of intimidation, restraint of dissenting opinions, and pressure to be part of the "Team," giving Chairman Franklin Raines and Vice Chairman Tim Howard the numbers the Office of the Chairman desired to please the markets. Employees like myself who refused to go along with this agenda were ostracized and subjected to retaliation. In fact, the straw that broke the camel's back for me occurred when I was deliberately excluded from assisting in the Company's preparation for the Office of Federal Housing Enterprise Oversight's ("OFHEO") review of Fannie Mae's accounting policies, practices, and internal controls, despite the fact that OFHEO's review concerned my very area of expertise, and the precise issues that I had been raising.

From 1998 to October 2003, I was employed by Fannie Mae as Manager of Financial Accounting, Deferred Assets, in the Company's Controller Division. I was one of the few employees within the Controller's Division who was both a certified public accountant and had an MBA. Beginning in 1999, and continuing each year thereafter, I repeatedly alerted Fannie Mae management to improper accounting practices, including the fact that the Company's Amortization Integrated Modeling System ("AIMS") used inaccurate methods that violated Generally Accepted Accounting Principles ("GAAP"), in particular Financial Accounting Standard ("FAS") 91. I also repeatedly advised management that it appeared that AIMS had been designed and employed to manipulate the level of income reported by Fannie Mae in its earnings statement and other public filings, which would constitute fraudulent conduct that violates federal law.

I communicated my concerns about AIMS' design and use to the managers in my direct line of supervision in the Controller's Division on a number of occasions, beginning in 1999 and continuing through 2003. In September 2002, I formally raised my concerns in an intraoffice memorandum to Franklin Raines, Fannie Mae's Chief Executive Officer ("CEO") and Tim Howard, the Company's Chief Financial Officer ("CFO"). When no corrective action was taken by either executive management or by the managers in the Controller's Division, I reported my concerns to the Company's Internal Audit division in July of 2003 and provided a wealth of materials documenting the pervasive and systematic nature of the accounting abuses about which I had repeatedly complained. The response from the Audit division, as detailed by OFHEO in its September 17, 2004 "Report of Findings to Date: Special Examination of Fannie Mae" was

incomplete, perfunctory, and ineffective. Unfortunately, this was not surprising given the climate at Fannie Mae – a climate in which inquiries by the Audit division were stonewalled and drowned out by the convoluted and deceptive explanations of managers who were determined to meet executive management's goal to depict stable and growing earnings regardless of the economic realities.

It was also not surprising, given the years of reprisal that I had suffered in trying to raise these concerns, that after I provided explicit and detailed evidence to the Office of Auditing, which demonstrated that the amortization accounting procedures used by Fannie Mae served to improperly manage income in violation of GAAP, Fannie Mae management escalated its retaliation against me ultimately forcing me from my employment.

Following is an account of what I endured in attempting to get Fannie Mae management to pay attention to the serious issues that the Committee is addressing today.

I began my employment with Fannie Mae in 1992 with the highest possible enthusiasm and the expectation that I would serve the corporate mission, benefit the United States housing market, and advance my own professional career. I began working in the Controller's division in 1994 as a Senior Financial Analyst, where I had responsibility for recording and analyzing monthly amortization income during monthly general ledger closings, coordinating and recording Fannie Mae's transactional activities with other business units, and reconciling the general ledger accounts. I also developed a deferred asset system, the Purchase Discount Integration ("PDI") system, which kept track of existing inventory, new acquisitions, monthly sales and adjustments of purchase discount and premium, deferred guaranty fees, and recorded amortization income and expenses.

In the first five years of my employment in Fannie Mae's Controller's division, I received excellent performance evaluations and was given increasingly greater levels of responsibility. In 1998, Fannie Mae promoted me to Manager of Financial Accounting, Deferred Assets. I maintained my Analyst responsibilities, and continued to manage PDI, but also took on additional duties, such as new product development, working with the tax department to resolve problems, and expanded corporate analysis for management's use.

In 1999, Fannie Mae began development of a new program to determine the rate at which to amortize Fannie Mae's assets. The Amortization Integration Modeling System ("AIMS"), was intended to serve as a modeling program to determine the cash flows and income generated by Fannie Mae's deferrals on mortgage and mortgage backed securities ("MBS") products. Jeffrey Juliane, another Manager in the Controller's division, led the development of AIMS. The collective management of the Controller's division, including me, were involved in and frequently discussed the development of the system.

From the outset of the development of AIMS, I expressed doubts about its validity and propriety during meetings and in conversations with my managers in the Controller's Division. The response from management was dismissive. On June 15, 1999, for example, Mr. Juliane had distributed a memorandum in which he stated that the purpose of the new amortization system would be to "manage the recognition of income and expense" more effectively than the programs in use at the time. During a meeting with Mary Lewers (Fannie Mae Director of Financial Accounting, and my direct supervisor) and Mr. Juliane, I indicated that Mr. Juliane's use of the term "manage" was problematic. It suggested, I observed, that the system would be used to manipulate the reporting of income and expenses, rather than for legitimate accounting purposes,

in violation of GAAP, in particular FAS 91. I also expressed concern that use of the system in that manner could cause Fannie Mae to issue materially inaccurate financial statements. Janet Pennewell, the Senior Vice President for the Company's Controller's division, joined the meeting as I was relaying this concern. She had no substantive response to my observation. Instead, she interrupted me, told me that modeling was Mr. Juliane's area, and that I should focus on PDI. This response was to become management's mantra over the next few years, as I continued to try to present my concerns to Fannie Mae management about the system's improper design and use.

Fannie Mae implemented the AIMS system in 2000. Thereafter, I became increasingly concerned about serious flaws in the program, and several of the Controller's division's processes related to amortization. I raised these concerns with Mr. Juliane and with our joint superiors. For example, I raised questions about repeated retroactive factor changes. I also questioned why the system employed factors that resulted in negative amortization, or in amortization that exceeded 100%, and why AIMS was designed and employed to not retain as audit trails each modeling sensitivity run that was executed. Ms. Pennewell, Ms. Lewers, and Mr. Juliane dismissed my concerns outright and denigrated my abilities. They told me that I did not understand the field well enough to offer an opinion. They also told me that they were working to accomplish the objective set by Leanne Spencer, Senior Vice President and Controller for Fannie Mae, and Tim Howard, Fannie Mae's Chief Financial Officer ("CFO"), which was to reduce the Company's earnings volatility.

On January 4, 2001, I participated in a meeting with Ms. Lewers, Richard Stawarz, Director of Financial Reporting, and Mr. Juliane, to discuss the effects of a recent cut in interest rates by the Federal Reserve. During the discussion, Mr. Juliane indicated that the rapid fall of

rates had led senior management to consider adjusting the "on-tops" — a term the Controller's division used to refer to manual journal entries that could be used to adjust arbitrarily the Company's income as the books were closed each month. Senior management had stated that "on-tops" could be used to reflect a desired amount of income for December 2000, which would maintain margin and net interest income levels. Mr. Juliane added that if the Company decided not to make "on tops" adjustments, he would produce modeling runs to support the desired income results. Mr. Juliane indicated that he was prepared to generate any results desired by Ms. Spencer and Mr. Howard through the modeling process. I was extremely troubled by what was clearly improper income management and asked Mr. Juliane if management agreed with this approach, which seemed to violate GAAP. Mr. Juliane told me that the Company's management embraced this approach.

On January 10, 2001, I alerted Ms. Lewers to a problem that arose when Mr. Juliane processed a factor change in December 2000, which included several errors. Specifically, the AIMS system had applied a set of factors to the wrong inventory, thereby placing into questions the AIMS system's reliability. When I voiced my opinion that the AIMS system might be inherently flawed, Ms. Lewers dismissed my concerns, again stating that modeling was Mr. Juliane's concern.

On February 1, 2001, Mr. Juliane sent an e-mail to several Controller's division employees, updating them on the incorporation of new factors into AIMS. Mr. Juliane stated that he had adjusted the net interest income factors "to evenly recognize $75 million of additional income in 2001, which [was] $50 million less than was originally forecasted in the plan." Mr. Juliane also stated that he had adjusted the guaranty fee factors to make the Company's actual

reported income comport with "the plan"-- i.e., management's statement of income goals for amortization purposes. The guaranty fee factor adjustment resulted in a $57 million adjustment for 2001. Troubled by the fact that Mr. Juliane's use of "the plan" seemed arbitrary, and the adjustments Mr. Juliane made appeared to be based on desired income results instead of loan prepayments, I told Ms. Lewers that I believed Fannie Mae was improperly engaging in income management. Ms. Lewers did not respond. However, later that same month, Ms. Pennewell threatened to transfer my responsibilities to Mr. Juliane and promote him to Director, making it clear to me that I would suffer adverse employment actions because of the issues I had raised. Only after I vigorously protested this decision did Ms. Pennewell refrain from removing my responsibilities.

On June 12, 2001, I discovered that during the closing of the Fannie Mae books for May 2001, the Company's management had posted a $10 million "on tops" entry in order to increase Fannie Mae's reported income. When I questioned Mr. Stawarz about this entry, he admitted that senior management made the "on tops" adjustment so that it could report more than Fannie Mae's actual income for the month, in order to support what management had previously set as earnings goals and margins. Thus, even if the Company did not actually meet the goals set by management, the use of the "on tops" adjustments allowed Fannie Mae to make it appear that it had met those goals in the relevant time period.

As I repeatedly asked questions and raised concerns about Fannie Mae's apparent income management through the use of modeling and last minute manual entries to the Company's books, as well as retroactive factor changes that were applied to previously closed accounting periods, Ms. Spencer, Ms. Pennewell, and Ms. Lewers increasingly excluded me from meetings,

communications, and discussions regarding Fannie Mae's modeling and amortization processes. They also sought to remove my responsibilities, thus ensuring that I did not have access to information regarding Fannie Mae's improper accounting practices.

Thus, on July 11, 2001, Mr. Juliane told me that Ms. Pennewell and Ms. Spencer wanted to transfer my responsibilities to him. Further, on July 20, 2001, the Controller's division management asked me to participate in a discussion of an Internal Audit division report, but failed to provide me with a copy of the report, which had been provided to all other Controller's division personnel participating in the meeting, including Mr. Juliane. By withholding this information from me in advance of the meeting, I was hindered in my ability to participate in a meaningful manner.

On August 10, 2001, I discussed my concerns regarding the Company's accounting practices with Richard Stawarz, Director. The discussions concerned Fannie Mae's use of factor changes and "on-top" adjustments to manipulate the amount of income the company reported each month, all of which I believed violated GAAP. Mr. Stawarz agreed with me that management often decided how much income they wanted to reflect before ensuring that such results could be achieved properly. He too expressed frustration and concern about this approach. However, Mr. Stawarz took no steps to rectify these problems.

On November 6, 2001, an amortization factor change requested by management resulted in a $100 million increase to the Company's interest income. I recognized this increase as concrete evidence that the AIMS system, as developed and used by the Company, produced grossly inaccurate and unreliable results when calculating Fannie Mae's income and expenses. On November 7, 2001, I informed Ms. Lewers that the integrity of the AIMS system was seriously

compromised, as evidenced by the $100 million increase to the Company's interest income. My concerns included that fact that the AIMS system was designed not to retain audit trails, making it impossible to accurately review the basis used to support the factors generated. Instead of investigating the issue or taking steps to address the problems I identified, Ms. Lewers told me that Mr. Juliane should provide an explanation for the factor change and its results. Management then approved the factor change.

During 2002, I continued to be concerned about serious flaws in AIMS and several of the Controller's division's amortization processes. I became aware that Fannie Mae was routinely using negative factors for discount and premium in order to revise current period net income. This use of negative factors allowed management to incorrectly report income by incorporating it into the balance sheet through accumulated amortization, thereby removing or adding income or expenses from the Company's income statement, even if those amounts had already been amortized. In May 2002, I informed Ms. Lewers that Fannie Mae's use of retroactive and negative factors had caused improper changes to the Company's reported income. As usual, Ms. Lewers dismissed my concerns and reiterated that this was Mr. Juliane's area, and not mine.

On June 13, 2002, after I realized Fannie Mae's use of negative factors had caused some of the Company's mortgage and MBS related assets to appreciate rather than to depreciate – a result completely inconsistent with GAAP and economic realities – I again raised concerns about the use of negative factors to Ms. Lewers and Mr. Stawarz. Ms. Lewers instructed me to speak with Mr. Juliane about the issue. When Mr. Juliane denied that there was any problem with the use of these factors, Ms. Lewers agreed and took no action to address the concerns I had raised.

By September 23, 2002, it was clear to me that management in the Controller's division had no intention of responding to my disclosures of accounting impropriety. Indeed, the culture in the Controller's division was such that many employees knew or suspected that the Company was regularly engaging in improper income management, and it became a joke that the Controller's division could produce any income statement that the Company wanted. I therefore sent a memorandum to Franklin Raines, Fannie Mae's Chairman, and to Mr. Howard, the Chief Financial Officer, regarding the serious financial improprieties I had repeatedly brought to the attention of my managers. Specifically, I highlighted the following: that reconciliation differences from systems were being input as future deferrals instead of the current period's income and expenses; that the Controller's division was intentionally limiting the AIMS system capabilities so that it would not provide audit trails for modeling; that the division had a practice of using negative factors in amortization and allowed amortization to exceed 100%; that the division routinely understated and overstated income; that the division managed income to meet the Company's desired objectives; that the division used On Top entries in order to manage income and margin calculations; and that the Company was using a miscellaneous balance sheet account in order to manage reporting of some income in periods other than when it was received. I also noted that there were serious problems with the amortization of purchased discount and premium, and that "the possible impact reaches hundreds of millions of dollars and possibly affects the integrity of the current financial statements and those we will issue after beginning compliance with SEC reporting in 2003." I urged Mr. Raines and Mr. Howard to investigate the issues identified.

Neither Mr. Raines nor Mr. Howard, nor anyone from their staffs, investigated these concerns or took corrective action. Thus, the practices I had identified continued, and I faced continuing reprisal for raising concerns about these issues.

Although I had sent the memorandum to Messrs. Raines and Howard as a "Finance Division Manager," without providing my name, the information I provided was easily traceable to me because I was one of only a handful of Managers who possessed any detailed information about Fannie Mae's amortization processes. Further, as noted, I had been raising similar concerns with my managers over the preceding several years.

Having seen no corrective action by Mr. Raines or Mr. Howard, at the beginning of October 2002, in a meeting of the Controller's division management, I asked questions regarding a number of the Company's accounting practices, including the practice of manipulating factors to generate desired levels of income, factor generation resulting in over 100% amortization of assets, the use of negative factors in amortization, use of "on-top" adjustments to manage income, and the Company's deliberate development of AIMS so that it would not retain audit trails of modeling runs generated and characteristics used, except those that the Company desired.

Instead of addressing the substance of my disclosures or correcting the serious problems I had identified, management escalated its retaliation against me. In November 2002, Fannie Mae took further steps to exclude me from discussions and meetings regarding all processes about which I had raised concerns, and also attempted to curtail my ability to raise concerns with Controller's division management. For example, Ms. Pennewell and Ms. Lewers eliminated the weekly individual meetings they usually had with me, and Ms. Lewers agreed to regularly meet

with me only in the presence of my staff. In the meantime, Ms. Pennewell and Ms. Lewers continued to regularly meet on an individual basis with other Managers who had not raised concerns about Fannie Mae's financial and accounting practices.

On November 22, 2002, when the Controller's division announced the recipients of the quarterly "Cool Rewards," I did not receive this monetary award for the work my staff and I had done on several large projects. Instead, Fannie Mae rewarded numerous other Managers and employees for their work on the very same projects, even though in some cases my staff and I had contributed more than the employees who actually received the awards. Disappointed and confused by the Company's blatant disregard for my efforts, I sent Ms. Pennewell and Ms. Lewers a memorandum requesting a meeting to discuss the program results. Neither manager responded to my memorandum. When I asked Ms. Lewers why neither she nor Ms. Pennewell had responded, she simply ignored the question.

On January 2, 2003, Ms. Lewers informed me that Ms. Spencer and Ms. Pennewell had decided that a more than $20 million correction to Fannie Mae's income would not be posted because of a concern that the correction would be noticed and questioned by the Company's Internal Audit division. Ms. Lewers indicated that the Internal Audit division might disagree with the Controller's division's use of "on-top" adjustments, but that the division would wait to see if Internal Audit raised questions before modifying this practice. In an effort to control the information conveyed to the internal auditors about the Company's use of "on-top" accounts, Ms. Lewers instructed me not to volunteer any information about these adjustments, and not to discuss the "on-top" account unless specifically asked. Ms. Lewers also reminded me of Ms.

Spencer's standing instruction that lower-level staff were not to speak with the Internal Audit division under any circumstances.

A few months earlier, in November 2002, I had applied for the Director of Finance in Securities Tracking Operations ("STO") position, which had been posted as a vacancy. After 10 years at Fannie Mae, combined with my previous experience, I was highly qualified for the position. However, after I filed my application in November, weeks passed and the Company made no mention of my application while it interviewed at least one outside candidate. Finally, three months after I submitted my application, Ms. Lewers informed me that she would interview me for the position. On January 28, 2003, the date of the interview, Ms. Lewers canceled, telling me that she had "other priorities [she wanted] to attend to." When the interview finally took place the next day, on January 29, 2003, Ms. Lewers arrived late even though she had been in her office shortly before the interview was to begin. Ms. Lewers did not have my resume, although I had submitted it with my application. She failed to take any notes during the interview, and spent most of the interview discussing her own experiences. Ms. Lewers made clear that the Company had no intention of actually considering me for the position and continued her practice, with the support and assistance of Ms. Pennewell, of excluding me from meetings and refusing to allow me to serve as an authority or leader on projects.

When employees asked questions of Ms. Pennewell or Ms. Lewers related to an area within my expertise, they instructed these employees to bypass me and to contact Mr. Juliane. Further, the Company failed to identify me on organizational documents, substituting Ms. Lewers as the lead on the PDI project even though, at the same time, it was all too willing to use my picture on its website and in its promotional materials, to tout the company's racially diverse

workforce. Although Mr. Juliane was only a Manager and also reported to Ms. Lewers, the Company consistently identified him in internal documents as the lead on the AIMS project. Fannie Mae also assigned several new projects to another Manager, Mary Trzeciak, even though I had expressed my desire to take on new projects, was more familiar with the project subjects than Ms. Trzeciak, and in some circumstances had to devote my own staff to assist Ms. Trzeciak in the performance of these duties.

The Company also began to undermine my authority by, for the first time, disagreeing with my positive assessments of the performance of my own employees. On February 25, 2003, Ms. Lewers and I met to discuss the performance reviews of my staff. Although I was a direct supervisor and had worked closely with my subordinates, Ms. Lewers disagreed with the ratings I recommended, demanding that I lower the ratings of two of my staff and raise the rating of my other staff member. Indeed, Fannie Mae's retaliatory treatment of me was now so blatant that my staff had earlier expressed concerns that the Company would downgrade their performance because I was their supervisor, thus seriously undermining my authority.

In March 2003, Fannie Mae hired Ilene Topper, an external candidate, into the Director of Finance in STO position for which I had applied in November 2002. I possessed many more years of experience within the industry and had more managerial experience than Ms. Topper, and was more qualified for the position.

In March 2003, when I received my performance evaluation for calendar year 2002, my managers lowered my summary rating a full level from "Fully Exceeds Expectations," the highest performance rating, to "Consistently Exceeds Expectations." For the first time, my evaluation contained negative comments about my "communication" and other interpersonal skills –

completely subjective criticisms that were inconsistent with all of the Company's prior evaluations of my abilities. These retaliatory criticisms were intended to silence me from speaking out further about my concerns.

In April 2003, I again spoke with Mr. Stawarz about my concerns regarding Fannie Mae's amortization accounting practices. I told Mr. Stawarz that I felt that it might be necessary to make the Company's management aware that several of the amortization accounting policies and procedures were not in compliance with GAAP, and affected the accuracy of Fannie Mae's financial reporting. Mr. Stawarz agreed that there were significant problems, but told me that in Fannie Mae's corporate climate – a climate in which employees actually joked about improper income management because it was such a regular occurrence, and a climate in which employee morale suffered because management offered promotions, bonuses, and perks only to employees who supported management's improper goals – I should not raise my concerns. As a result of this discussion, I decided to undertake a detailed study of Fannie Mae's amortization accounting and other areas in which I had noticed irregularities, in order to document the seriousness and prevalence of these irregularities.

I began a detailed study of the unamortized balances I had come across as part of my responsibility for 400 general ledger accounts. Over a period of weeks, I painstakingly reviewed the Company's amortization transactions and found abundant evidence of the same kinds of problematic and unlawful financial practices I had identified in my September 23, 2002 memorandum to Mr. Raines and Mr. Howard.

In May 2003, I offered substantial assistance to members of the Internal Audit division who were conducting a routine audit. I attempted to discreetly alert the internal auditors to the

serious problems I had identified to my managers and was discovering through my own reserach. The auditors failed to investigate the concerns I raised. On May 28, 2003, in a meeting of the Financial Accounting and Internal Audit divisions, the auditors nonetheless openly praised me for the time I devoted to assisting them and for my "openness." This praise provoked visible displeasure on the part of Ms. Lewers.

Only a few weeks later, Fannie Mae initiated the Portfolio Investment Business Strategy project, which was to be a large and highly visible project within the Controller's Division, requiring significant contributions from the PDI unit. Ms. Pennewell selected Mr. Juliane to participate in the project rather than me, even though I was the Manager responsible for PDI. Mr. Juliane was assigned to represent my unit in addition to his own, notwithstanding the fact that he knew virtually nothing about PDI. Indeed, in the weeks that followed, Mr. Juliane found it necessary to consult with me on a regular basis regarding PDI.

On July 23, 2003, I completed my research regarding Fannie Mae's unamortized balances. Over the past months I had confirmed and documented my earlier suspicions that Fannie Mae's general ledger accounts reflected a large number of irregular unamortized balances, that there were numerous amortization factor errors produced by the modeling system, and that the amortization speeds employed by the Company frequently conflicted with GAAP and economic realities. Upon completing my research and confirming that there were significant problems with Fannie Mae's amortization accounting, I attempted to set up a meeting with Sam Rajappa, the head of the Internal Audit division.

On July 28, 2003, I alerted Ms. Lewers to a major problem with a July 2003 factor change. This factor change produced an unusually large number of factor errors, resulting in

approximately 40 pages of errors. As I had done on numerous prior occasions, I again told Ms. Lewers that there were serious problems with the AIMS system and how it was being used by Fannie Mae. I also expressed concern to Ms. Lewers regarding Mr. Juliane's request that I provide him with expected PDI results before corrections were made. I told Ms. Lewers that I thought these requests were a clear sign that the Company intended to intentionally misstate income, and informed Ms. Lewers that Mr. Juliane's requests were a clear red flag of improper practices. Ms. Lewers made no comment and took no action to address the concerns I had raised. She appeared visibly displeased with me for continuing to raise these issues.

Judging from Ms. Lewer's response to my concerns and management's dismissive attitude, I feared that my managers would ignore the results of my study and engage in further acts of retaliation against me. Accordingly, on July 29, 2003, I again attempted to set up a meeting with Mr. Rajappa, this time by e-mail. I wrote Mr. Rajappa, "it is necessary that I schedule an important meeting with you regarding analysis and research I have been conducting for a number of weeks," and I informed him that he might wish to invite other members of his staff – Ann Eilers, Paul Jackson, and/or Joyce Philip – who were familiar with the subject matter I needed to discuss.

Later on the same day that I e-mailed Mr. Rajappa alerting him to my concerns, Ms. Pennewell informed me that the Company had promoted Mr. Juliane to Director, and that I would report to him. When I asked why Fannie Mae had not selected me for promotion, Ms. Pennewell told me that I needed to have more responsibilities before I would be promoted, and that I needed to show a willingness to accept more responsibility and to make sacrifices. I was obviously displeased with this blatantly retaliatory decision by Fannie Mae to pass me over for promotion,

yet again. I explained to Ms. Pennewell that it violated internal controls for me to report to Mr. Juliane, since he would then be responsible for both the AIMS and PDI systems, and would be in charge of both the accounting and estimating sides of amortization accounting. Ms. Pennewell told me that she would convey my concerns to Ms. Spencer, but that the change had already been made.

When I spoke with Ms. Lewers about the decision to promote Mr. Juliane and the internal control problems presented by my reporting to Mr. Juliane, Ms. Lewers informed me that she and Ms. Spencer had supported the decision, and that, in order to be promoted, I needed to "communicate differently by pausing, listening, and interpreting the signals from [my] audience."

These explanations for my non-promotion were clearly pretextual and were further evidence of the Company's determination to marginalize me as punishment for my refusal to stop questioning Fannie Mae's improper accounting practices. During my entire tenure with the Controller's division, I always volunteered to take on additional responsibilities, and indeed had more responsibilities than Mr. Juliane. Further, until my performance review for 2002, which occurred after my disclosures, my supervisors had always rated my interpersonal skills very highly, and the Company had even selected me to provide Continuing Professional Education training to other employees. Indeed, when I pressed Ms. Lewers for an explanation of her suggestion that I communicate differently, she was unable to provide a coherent response. In addition, Ms. Pennewell told me that the Company wanted me to help Mr. Juliane and wanted to "leverage" my knowledge, people skills, and project management skills to help make Mr. Juliane successful. Ms. Pennewell also threatened me that, "if you're smart and you know what's good for your career, you'll get behind this decision."

I was far more qualified than Mr. Juliane for the Director position. Mr. Juliane is not a CPA and had little accounting background, yet the Director position required that Mr. Juliane supervise several accounting functions. However, unlike me, Mr. Juliane had not raised concerns about the improper use of the AIMS system, and, in fact, was instrumental in developing the system in such a way that it produced results inconsistent with GAAP. When Ms. Pennewell announced Mr. Juliane's promotion to the Cash Control and Amortization business units I supervised, several of my employees asked me why I had not been promoted, much to my embarrassment and humiliation.

During the meeting on July 29, 2003, Ms. Pennewell also informed me that the Company had promoted a new manager, Jennifer Wall, to the position of Director of Financial Reporting. This position was never posted, and the Company apparently never considered me for it even though I had more experience than Ms. Wall within the Controller's division, at Fannie Mae, in the industry, and as a manager.

On August 1, 2003, Mr. Juliane requested yet another factor change that I found extremely disturbing. During the July 2003 closing, the Controller's office management indicated, during routine meetings related to the monthly closing, that Fannie Mae's net interest income for the month would be approximately $6.5 million less than management had projected. My group's preliminary amortization had already been completed. However, on August 1, 2003, Mr. Juliane told me that there was a single factor error in one FAS91 type that needed to be corrected. When I asked Mr. Juliane for documentation to support the factor change and to create an audit trail, he was unable to provide any at the time. Only later did Rene LeRouzes, a member of Mr. Juliane's staff, produce data in an e-mail memorandum that represented the factor. When I processed the

new factor change, I was shocked to realize that the impact of the new factor change turned out to be an increase in income of $6.5 million. Given the exact match between the results of the factor change and the income shortfall management had commented on only a few days earlier, I strongly suspected that management was preparing to intentionally misstate income to achieve its desired result of creating a picture of stable earnings.

On August 4, 2003, I met with Mr. Rajappa and Ms. Eilers of the Internal Audit division. I gave them a memorandum titled "Unamortized Balances And Factor Analysis" that summarized the findings of my substantial research of the previous months. The memorandum raised several concerns regarding Fannie Mae's accounting practices, including: the inadequacy of controls and review of accounting processes; the AIMS system's failure to retain audit trails; the lack of correlation between factors and loan prepayments; the inaccuracy of Fannie Mae's financial statements as a result of the arbitrary selection of factors; the lack of adequate checks and balances for the PDI and AIMS systems; the problem of on top adjustments; the problem of deferred assets being amortized in excess of 100% or in reverse; and the fact that improper amortization speeds were being used. All of the practices I highlighted were ones that caused Fannie Mae to not be in compliance with GAAP.

In addition, I provided Mr. Rajappa and Ms. Eilers with approximately 60 examples of factor errors and other analyses that I had completed relevant to the issues I raised. These 60 examples were all taken from the period ending June 30, 2003. I also alerted Mr. Rajappa and Ms. Eilers to the most recent $6.5 million factor change, which I believed was an example of intentional misstatement of income. I told Mr. Rajappa and Ms. Eilers that, based on my research, I believed that Fannie Mae's amortization accounting was not in compliance with

GAAP, and that the Company was manipulating and managing income in order to create a picture of artificially stable earnings.

On August 5, 2003, I gave Ms. Spencer, Ms. Pennewell, Ms. Lewers, and Messrs. Stawarz and Juliane a copy of what I had provided to the Internal Audit division, including documentation reflecting the over 60 factor errors I had discovered for the period ending June 30, 2003. That same day, Ms. Spencer, Ms. Pennewell, Ms. Lewers, and Mr. Juliane convened a meeting to discuss my disclosures. During that meeting, Ms. Spencer, Ms. Pennewell, and Ms. Lewers expressed their anger that I had taken my concerns to the Internal Audit division, criticized the language I had used in describing the problems, and faulted me for allegedly "overstating the case." None of the managers even raised the idea that a review of the amortization accounting processes should be initiated. Instead, they criticized me for informing Internal Audit of my concerns, and Ms. Pennewell shouted at me and interrupted me when I attempted to speak. However, Mr. Juliane admitted that my data and research were accurate, and that there were issues regarding modeling that his team had been struggling with. When Ms. Spencer, Ms. Pennewell, and Ms. Lewers nodded in agreement, it was clear that they each already knew that there were major problems with the modeling performed by the AIMS system. However, they had all failed to take steps to correct the problems, and instead allowed factors generated by AIMS to be used in amortization processing.

On August 8, 2003, Mr. Rajappa convened a meeting of the Controller's Office managers, including, among others, me, Jonathan Boyles of the Financial Standards division, Ms. Eilers, Ms. Philip, Paul Jackson, and Gunes Kulaligil of the Internal Audit division, Deborah House from the Office of Corporate Justice, and two representatives from KPMG, Fannie Mae's external

auditors. Although I had hoped that the purpose of the meeting would be to discuss how to rectify the problems I had identified, it quickly became clear that the purpose of the meeting was to determine how to justify the improper practices I had identified so that Mr. Raines could certify Fannie Mae's financial statements by an August 15, 2003 deadline.

Initially, representatives from the various departments all blamed each other for the problems, and the atmosphere was extremely tense. Eventually, however, Mr. Juliane gave a complex explanation for the accounting issues I had raised. Although these answers did not justify Fannie Mae's non-compliance with GAAP, and were in several instances contradictory, Mr. Rajappa appeared eager to accept Mr. Juliane's explanations. Ms. Spencer and Ms. Pennewell also concurred with Mr. Juliane's explanations and the KPMG representatives stated that GAAP was being followed, although they cautioned that they had not conducted a formal audit. Mr. Boyles and Mr. Rajappa then both stated that the amortization process was in accordance with Fannie Mae policy and GAAP. Although it was not possible for the Internal Audit division to have investigated fully the concerns I raised in the short period of time that had passed since I first provided them with details of my concerns, no further action was recommended to investigate or truly resolve the serious concerns I had raised.

When Ms. House questioned the $6.5 million factor correction adjustment to income during this meeting, I stated my concerns that the factor correction deliberately made PDI comport with management objectives. Ms. Pennewell responded that AIMS, the modeling and forecasting system, was the source system instead of PDI, the production system, and that PDI should produce the results projected by AIMS. This explanation of the two systems was inaccurate and endorsed a process of amortization accounting that fundamentally violates GAAP.

However, no one at the meeting, including those with accounting expertise, corrected Ms. Pennewell.

As a Manager, I was the lowest-ranked employee at the meeting, and I felt enormous pressure to agree with the other Directors, Vice Presidents, and Senior Vice Presidents, in their attempts to explain away the concerns I had raised with the explicit purpose of allowing Mr. Raines to certify the June 2003 financial statements. When Mr. Rajappa stated that the amortization process was in accordance with Fannie Mae policy and GAAP, he asked if anyone disagreed with that conclusion. Faced with enormous pressure from my superiors, and fully aware that no one at the meeting appeared interested in fixing the problems, I did not voice my disagreement. However, on October 2, 2003, I sent an e-mail to Mr. Jackson indicating that I did not endorse the investigation completed by the Internal Audit division.

After I disclosed my findings to the Internal Audit division, Fannie Mae excluded me from all meaningful participation in the Controller's division processes. Ms. Spencer, Ms. Pennewell, and Ms. Lewers no longer informed me of meetings of the Controller's division management, even when my areas of responsibility were directly involved. Further, Mr. Juliane, who was now my supervisor, maintained only minimal contact with me.

Further, Fannie Mae excluded me from almost all discussions of the improper financial and accounting practices I identified, and made efforts to conceal my disclosures from relevant authorities. For example, even though I had formally placed the Company on notice of flaws in Controller's division processes that resulted in the understatement and overstatement of income, on August 14, 2003, Mr. Raines did certify financial statements, which contained information generated by the Controller's division's processes that I had repeatedly questioned.

Further, Fannie Mae deliberately excluded me from assisting in the Company's preparation for OFHEO's review of Fannie Mae's accounting policies, practices, and internal controls. On October 3, 2003, the Company sent an e-mail to its financial management, including employees at or below my Manager level, regarding the need to retain documents pertinent to OFHEO's investigation. However, Fannie Mae did not send the e-mail to me, even though I had direct knowledge and involvement in the areas OFHEO planned to investigate, and despite the fact that other Managers were included in the e-mail. In fact, Fannie Mae had failed to even inform me that OFHEO was planning a review of the Company's accounting policies, which certainly included my areas of responsibility.

As a result of Fannie Mae's refusals to take the concerns I had raised about financial and accounting practices seriously, and the retaliation I faced for raising these concerns, I had no choice but to separate from the Company in October 2003.

CONCLUSION

Again, I want to thank the members of the Subcommittee for taking the time to review my testimony. The story I have related is, obviously, important to me personally. I have presented it to you in the hopes that by sharing my experiences, I will have conveyed the importance of protecting individuals who step forward and report improprieties and irregularities they observe at Fannie Mae.

Report of Findings to Date
Special Examination of Fannie Mae

Office of Compliance
Office of Federal Housing Enterprise Oversight

September 17, 2004

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET, NW, WASHINGTON, DC 20552 (202) 414-3800
Office of Compliance

MEMORANDUM

TO: Armando Falcon, Jr., Director

FROM: Christopher H. Dickerson, Chief Compliance Examiner

SUBJECT: **Fannie Mae Special Examination**

DATE: September 17, 2004

Attached are the findings to-date of the special examination of Fannie Mae. The matters detailed in this report are significant and warrant your immediate attention.

This report is the result of a collective effort by the Office of Compliance, the Office of the Chief Accountant, and other OFHEO staff, as well as technical support provided by accountants from Deloitte & Touche, LLP. During our examination, we have reviewed more than 200,000 documents and e-mails, and have interviewed and taken sworn testimony from numerous current and former Fannie Mae employees.

Our examination is continuing and we will keep you apprised of our findings.

Report of Findings to Date
Special Examination of Fannie Mae

Office of Compliance
Office of Federal Housing Enterprise Oversight

September 17, 2004

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INTRODUCTION AND EXECUTIVE SUMMARY

We are currently conducting a Special Examination of Fannie Mae's accounting policies, internal controls, and financial reporting processes. Although the examination is still in process, our findings to-date are serious and warrant a report at this juncture. This report details the Special Examination's concerns on the framework and conditions of Fannie Mae's accounting policies and internal controls, with a particular focus on two critical accounting areas: deferred price adjustments, and derivatives and hedging activities.

We have determined that Fannie Mae, in developing policies and practices in these critical areas, has misapplied Generally Accepted Accounting Procedures ("GAAP"), specifically *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* ("SFAS 91") and *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"). The misapplications of GAAP are not limited occurrences, but are pervasive and are reinforced by management. **The matters detailed in this report are serious and raise concerns regarding the validity of previously reported financial results, the adequacy of regulatory capital, the quality of management supervision, and the overall safety and soundness of the Enterprise.**

The problems relating to these accounting areas differ in their specifics, but they have emerged from a culture and environment that made these problems possible. Characteristics of this culture include:

- management's desire to portray Fannie Mae as a consistent generator of stable and growing earnings;
- a dysfunctional and ineffective process for developing accounting policies;
- an operating environment that tolerated weak or non-existent internal controls;
- key person dependencies and poor segregation of duties;
- incomplete and ineffective reviews by the Office of Auditing;
- an inordinate concentration of responsibility vested with the Chief Financial Officer; and
- an executive compensation structure that rewarded management for meeting goals tied to earnings-per-share, a metric subject to manipulation by management.

The tenor of earnings management is deeply ingrained at Fannie Mae and has given rise to accounting policies and practices that emphasize effects on earnings volatility, rather than faithfulness to GAAP. A key message by Fannie Mae to the investor community is management's ability to generate stable and growing earnings. This is evidenced by Fannie Mae's annual financial reports, with their recurring graphs of steadily increasing earnings against a backdrop of volatile interest rates. Less well known, but detailed in this report, is the fact that the desire by management to minimize earnings volatility was a central organizing principle in the development of key accounting policies.

Management also emphasized the stable earnings imperative in its communications to the Fannie Mae Board of Directors. In July 2003, even as the accounting problems of Freddie Mac were publicly emerging, Fannie Mae's Chief Financial Officer, Tim Howard, made a presentation to the Board that emphasized a "stable pattern of earnings" as a requirement for Fannie Mae if it were to be perceived as a low-risk Enterprise. Mr. Howard included in this presentation a

graph showing that the earnings of Fannie Mae were smoother than those of Freddie Mac and almost all other companies in the S&P 500.

Sound risk management practices can reduce the economic effects of volatile cash flows. However, management should not reduce earnings volatility through accounting policies and practices that do not comport with GAAP.

The key findings of our examination relating to SFAS 91, SFAS 133, accounting policy development, and internal controls are summarized below.

Accounting for Purchase Discount and Premium and Other Deferred Price Adjustments (SFAS 91)

OFHEO has concluded that the accounting used by Fannie Mae for amortizing purchase premiums and discounts on securities and loans as well as amortizing other deferred charges is not in accordance with GAAP. This is particularly significant, in that management, in the MD&A section of their Form 10-K, details their underlying application of amortization as it relates to SFAS 91, and also explains that the accounting estimates associated with deferred price adjustments are "critical accounting estimates."

However, despite the importance of premium and discount amortization to the financial statements of Fannie Mae, and despite the requirement of SFAS 91 to formulate best estimates in good faith, management intentionally developed accounting policies and selected and applied accounting methods to inappropriately reduce earnings volatility and to provide themselves with inordinate flexibility in determining the amount of income and expense recognized in any accounting period. In this regard, the amortization policies that management developed and the methods they applied created a "cookie jar" reserve. In addition, OFHEO found that management:

- deliberately developed and adopted accounting policies to spread estimated income or expense that exceeded predetermined thresholds over multiple reporting periods;
- established a materiality threshold for estimated income and expense, within which management could avoid making adjustments that would otherwise be required under SFAS 91;
- made discretionary adjustments to the financial statements, for the sole purpose of minimizing volatility and achieving desired financial results;
- forecasted and managed the future unrecognized income associated with misapplied GAAP;
- capitalized reconciliation differences as 'phantom' assets or liabilities and amortized them at the same speeds as 30-year fixed-rate mortgages;
- developed estimation methods that were inconsistently applied to retrospective and prospective amortization required by SFAS 91 for current and future periods;
- developed and implemented processes to generate multiple estimates of amortization with varying assumptions in order to select estimates that provided optimal accounting results;
- failed to properly investigate an employee's concerns regarding illogical or anomalous amortization results, along with that employee's further allegation of an intent to misstate reported income;

- tolerated significant weaknesses in internal controls surrounding the amortization process; and
- inappropriately deferred $200 million of estimated amortization expense in 1998, which had significant effects on executive compensation.

This report provides details on the thresholds established by management for recognizing – or not recognizing – amortization income or expense. Although management often refers to the amounts within these thresholds as "the functional equivalent of zero", our report details why, in fact, the ranges of these thresholds are quite large relative to the amounts of amortization normally recognized, how the ranges greatly facilitate the smoothing of income, and why these thresholds fail the test of GAAP compliance.

This report chronicles the events that led to the development of Fannie Mae's current amortization policies and practices. It describes how management, after experiencing unexpected increases in amortization expense in 1998, developed policies and practices to cushion the income statement against future surprises. In various memoranda, management openly expressed as an objective of its amortization policies and practices a desire to minimize earnings volatility. For example, a March 1999 memorandum from an employee in the Controller's Department described the benefits of a particular brand of software for modeling amortization, noting that the software allowed a user to "manipulate factors to produce an array of recognition streams", which "strengthens the earnings management that is necessary when dealing with a volatile book of business."

This statement is a clear acknowledgement that a balance sheet comprised of fixed-rate mortgages produces volatility. However, in testimony that is highlighted in this report, management sought to portray their amortization policies and practices as attempts to dampen "artificial volatility" that arises from the estimation process. Chief Financial Officer Tim Howard, who was the chief architect of Fannie Mae's amortization policy, attempted to justify the use of a discretionary threshold for recording amortization by asserting that a single point-estimate resulted in "spurious precision." In fact, said Controller Leanne Spencer, management's freedom to book a number within this range was useful to investors, because doing so helped eliminate "jerky moves."

Management asserts that the "artificial volatility" they seek to dampen arises from assumption risk. Because key assumptions, such as mortgage prepayment speeds, can change dramatically from period to period, estimates of amortization can likewise change dramatically. However, changes in prepayment assumptions are driven by actual changes in the economic environment, particularly changes in interest rates, which gives rise to volatility. **GAAP requires this volatility to be recognized and reported.**

In arguing against the use of a single point-estimate for amortization, management has also asserted that estimates of prepayments may vary widely at any particular point in time. For example, one can survey Wall Street dealers and observe a wide range of prepayment estimates, any of which could be justified for estimating amortization. In fact, management sometimes obtains many prepayment estimates from market sources and, for particular asset categories, selects a speed within the range of estimates to develop amortization factors. Management asserts that any prepayment estimate within the range can be justified, but in fact the flexibility to select any prepayment speed within a range simply enhances the ability of

management to hit an earnings number. Because these estimates of amortization are also used in management's analysis of net interest income sensitivity, this practice has unfavorable safety and soundness implications that go beyond financial reporting.

The Special Examination also found that the process for estimating amortization was characterized by significant control weaknesses. Many of these control weaknesses are centered on the amortization system and the process for modeling amortization factors. **These control weaknesses undermine the process of amortization to such an extent that the accuracy of premium and discount amortization is questionable.** These control weaknesses include:

- inadequate segregation of duties and key person dependencies;
- modeling multiple runs to produce desired results;
- underlying data issues, including illogical or anomalous amortization factors; and
- a lack of written procedures, supporting documentation, and poor or non-existent audit trails.

This report also details an investigation performed by the Office of Auditing into allegations of amortization accounting irregularities raised by Roger Barnes, a former employee in the Controller's Department who left Fannie Mae in November 2003, and whose cooperation was important to our examination. The Special Examination found that Mr. Barnes's allegations were substantive, and that the Office of Auditing failed to adequately investigate the problems surrounding the amortization process that he raised.

The consequences of the misapplications of GAAP and control breakdowns surrounding accounting for amortization are potentially large. The management of Fannie Mae, by recording incorrect and incomplete amounts of premium and discount amortization, has misstated interest income over many reporting periods, as well as balance sheet accounts for unamortized premiums and discounts. Also, because amortization estimates ultimately flow to individual securities, gains or losses recorded on the sale or transfer of securities in previous periods are also questionable. Fannie Mae will need to devote considerable resources to determine the full magnitude of these errors.

Accounting for Derivative Instruments and Hedging Activities (SFAS 133)

Fannie Mae adopted SFAS 133, *Accounting for Derivative Instruments and Hedging Activities,* on January 1, 2001. The standard requires that all freestanding and certain embedded derivatives be carried on the balance sheet at fair value. Changes in the fair value of a derivative are included in earnings, which gives rise to earnings volatility. However, the hedge accounting provisions of SFAS 133 provide methods for offsetting the earnings effect of a derivative with a designated hedge transaction, if the combination meets specific criteria. **Hedge accounting is optional**. To qualify, entities must maintain extensive documentation and, in many instances, perform rigorous calculations. These stringent criteria presented significant challenges to Fannie Mae, which has a large and dynamic hedging program.

Fannie Mae had a strong desire to retain the *status quo* of accrual/synthetic instrument accounting in effect before SFAS 133, because synthetic instrument accounting provided smoother accounting earnings and greater predictability of reported financial results. To this

end, **Fannie Mae implemented SFAS 133 in a manner that placed minimizing earnings volatility and maintaining simplicity of operations above compliance with GAAP.** These goals, to an inordinate degree, influenced the development of Fannie Mae's approach to hedge accounting.

Indeed, in a March 2003 memorandum that took a retrospective look at Fannie Mae's SFAS 133 implementation, Jonathan Boyles, Senior Vice President for Financial Standards, wrote that the implementation of this standard was driven by management's desire to minimize earnings volatility, leverage off existing systems, and make the non-GAAP measure of "operating earnings" simple and easy to understand. Mr. Boyles wrote that these goals "were intertwined in many of the decisions we made during the implementation process." He went on to write that these decisions "were often the joint decisions of management including the CFO." He further noted that "in hindsight these decisions may not have been the best decisions given what we know now."

These drivers did, in fact, result in major problems for Fannie Mae's accounting for derivatives. In fact, **OFHEO has found that in many cases Fannie Mae does not assess and record hedge ineffectiveness as required by SFAS 133, and applies hedge accounting to hedging relationships that do not qualify.**

Fannie Mae's hedge accounting regime assumes that the vast majority of its hedging relationships are "perfectly effective"; this greatly simplifies operations, because SFAS 133 requires no effectiveness assessment or measurement of ineffectiveness for such relationships. However, SFAS 133 prescribes specific rules for assuming perfect effectiveness; hedges that do not meet these criteria require an assessment of effectiveness to qualify for hedge accounting and a measurement of ineffectiveness for qualifying hedge relationships. **OFHEO's analysis indicates that Fannie Mae has many hedging relationships that do not qualify as perfectly effective, yet have been treated as such.** Because Fannie Mae has not performed a proper assessment of hedge effectiveness for such hedges, these hedge relationships do not qualify for hedge accounting treatment. Thus, **the fair value changes for derivatives in these relationships should be recorded in earnings.**

Even if a hedge relationship qualifies for hedge accounting, "ineffectiveness" may exist. Ineffectiveness represents the extent to which changes in the fair value of a derivative are not perfectly matched with the changes in fair value or cash flows of the hedged item. The ineffective portion of changes in the derivative's fair value must be recorded in earnings. OFHEO has identified numerous instances in which **Fannie Mae has improperly ignored this ineffectiveness in hedge relationships or has failed to perform assessment tests.** For example, Fannie Mae often re-designates derivatives to different hedged items during the life of the derivative. OFHEO found that Fannie Mae incorrectly assumes that such derivatives are perfectly effective upon re-designation, even though the derivatives do not have a fair value of zero at the time of re-designation. This is required in order to assume perfect effectiveness or to receive matched terms accounting.

Further, **Fannie Mae has applied the "short-cut" method, or the "matched terms" method, for a broad range of hedge relationships where these methods are inappropriate.** The Enterprise has also applied its own definitions of "matched terms" in certain instances. Examples detailed in this report include:

- receive-fixed swaptions hedging the fair value of non-callable debt;
- callable swaps hedging discount notes, which are incorrectly treated as perfectly effective without regard to the option value existing in the derivative but not the hedged item;
- swaps arising from the exercise of a swaption, which are treated as perfectly effective despite their non-zero fair value at inception;
- the modification of the requirement for matching of reset dates (in order to assume perfect effectiveness) between the hedged item and the swap in cash flow hedges to permit up to a seven day reset date mismatch;
- the modification of the requirement for matching of maturity dates (in order to assume perfect effectiveness) between the hedged item and the swap in fair value hedges to permit up to a 90 day mismatch; and
- the use of a "duration method" to assume perfect effectiveness in hedges of anticipated debt issuances. (In March 2004, Fannie Mae discontinued the use of duration matching as a method to assess the effectiveness of hedging anticipated debt issuances. The Enterprise admits that this methodology was a known departure from GAAP.)

When seeking to effectively terminate interest rate swaps, management often entered into offsetting swaps instead of buying back the existing swaps. However, the accounting for offsetting derivatives was inappropriate through the end of 2003, because **Fannie Mae incorrectly treated the original swap and the offsetting swap as perfect cash flow hedges and recorded changes in their fair value in accumulated other comprehensive income (AOCI), instead of earnings.** In the first quarter of 2004, Fannie Mae modified its accounting for these offsetting swaps prospectively. However, OFHEO believes that these offsetting swaps were not valid hedging relationships under SFAS 133 in past periods and should not have received hedge accounting after the execution of the second swap.

OFHEO identified a number of problems with Fannie Mae's hedge documentation. In several examples OFHEO reviewed, the documentation was ambiguous as to the nature of the hedging relationship or did not clearly identify the hedged risk, hedged item, or its probability of occurrence. In addition, OFHEO found instances where there was no contemporaneous hedge documentation, as well as instances where staff created hedge designations retroactively. Under SFAS 133, the lack of contemporaneous hedge designation documentation precludes a company from qualifying for hedge accounting. **This lack of documentation and the ability to create such documentation retroactively is not only a SFAS 133 violation, but is evidence of a poor control framework and is a significant safety and soundness problem.**

This report also provides details on an error made by Fannie Mae in accounting for changes in the time value and the intrinsic value components of purchased interest rate caps. The Enterprise discovered the error, corrected its methodology, and applied the new methodology only prospectively to new interest rate caps. The analysis and discussion in this report show that **Fannie Mae has incorrectly accounted for and reported this error in its financial statements.** Further analysis is necessary to make a precise determination of the complete financial statement impact on all periods affected.

For derivatives not qualifying for hedge accounting, fair value changes should be reflected in earnings in the period in which the value change occurred. As of December 31, 2003, the balance in "Accumulated Other Comprehensive Income" (AOCI) included approximately $12.2 billion in deferred losses relating to cash flow hedges. Furthermore, carrying value adjustments of liabilities relating to fair value hedges amounted to $7.2 billion as of that date. Fannie Mae's improper application of hedge accounting leads us to question the validity of the amount reflected in AOCI, as well as amounts reflected as carrying value adjustments, at any point in time after the adoption of SFAS 133. **The possible reclassification of such amounts into retained earnings could have a significant effect on Fannie Mae's regulatory capital.**

Accounting Oversight

As part of the Special Examination, we assessed various controls and processes surrounding Fannie Mae's accounting and financial reporting. These include processes for developing, approving, maintaining, and implementing accounting policies, as well as the segregation of duties and key person dependencies. In particular, we concentrated examination efforts on evaluating the roles and responsibilities of the Chief Financial Officer, executives in the Controller's Department, and controls that support the integrity of the financial reporting process.

The failure by management to properly implement critical accounting policies is due in part to the lack of a sound framework for developing these policies. Fannie Mae often relies on a few individuals to make key decisions on critical accounting policies and practices. This report documents how management failed to establish an internal control system to ensure that accounting policies are appropriately developed and reviewed.

A prime example of this failure is the process for developing the key document relating to SFAS 91 accounting. OFHEO found that Fannie Mae's *Purchase Premium and Discount Amortization Policy* was developed without input from the Financial Standards, which is the group in the Controller's Department normally responsible for setting accounting policy. Indeed, the head of that group, Jonathan Boyles, testified that key provisions of that document do not comply with GAAP.

Our report documents that Fannie Mae's external auditor, KPMG, is often viewed within the Enterprise as the final arbiter of compliance with GAAP. However, it is ultimately the responsibility of management to determine sound accounting policies for the Enterprise – the burden of management can not be shifted to the external auditor. OFHEO views this reliance on the external auditor to determine the propriety of accounting policy as an indication of inadequate technical expertise within the Controller's Department. OFHEO found that the accounting policy review process does not provide reasonable assurance that the accounting policies adopted by the Enterprise are in compliance with GAAP.

The control weaknesses that we identified in Fannie Mae's accounting policy development process have contributed to accounting policies that do not comply with GAAP. Additionally, the Special Examination found that a lack of formal procedures for accounting policy development has resulted in incomplete disclosure of critical accounting policies by the Chief Financial Officer to the Audit Committee of the Board of Directors.

A cornerstone of sound corporate oversight is the control structure itself. It is management's responsibility to ensure that Fannie Mae operates in a safe and sound manner and has proper segregation of duties, an adequate level of controls to support its key business processes, and clear and appropriate accounting policies. In addition, it is the responsibility of management to ensure that personnel in key control functions are competent and qualified to execute their responsibilities. In this regard, OFHEO found that a combination of heavy workloads, weak technical skills, and a weak review environment contributed to the development of key person dependencies and inadequate segregation of duties.

The Special Examination found that the Chief Financial Officer, Tim Howard, failed to provide adequate oversight to key control and reporting functions within Fannie Mae. Mr. Howard oversees the Controller's Department, which does not possess the skills required to ensure that Fannie Mae has appropriate accounting policies, the resources to appropriately implement such policies, nor an effective system of internal controls. In addition, the Chief Financial Officer significantly influences the evaluation of the head of the Office of Auditing, and makes compensation recommendations for him. This decreases the independence and effectiveness of the internal audit function and is inappropriate.

With respect to key person dependencies, we found that the Chief Financial Officer also serves as the Chief Risk Officer of Fannie Mae, and is directly responsible for overseeing the Enterprise's Treasury and Portfolio Management functions, in addition to the Controller's Department. **The combination of these responsibilities does not provide the independence necessary for an effective Chief Risk Officer function.** We further found that Mr. Howard was instrumental in setting financial targets as Vice Chairman, and had the authority to meet these targets as Chief Financial Officer.

Additionally, we found inherent conflicts in the roles assigned to key managers and executives. For example, Janet Pennewell, Senior Vice President for Financial Reporting and Planning, has the ability to affect the amounts of reported net income in order to achieve results that her group forecasted. In the critical area of purchase premium and discount amortization, the Special Examination found that one director, Jeff Juliane, has responsibility for modeling, reporting, and accounting.

Fannie Mae's dysfunctional accounting policy development, key person dependencies, and poor segregation of duties were major contributors to the accounting failures and the safety and soundness problems detailed in this report.

ACCOUNTING FOR PURCHASE DISCOUNT AND PREMIUM AND OTHER DEFERRED PRICE ADJUSTMENTS UNDER SFAS 91

OFHEO has concluded that Fannie Mae's accounting for the amortization of purchase premiums and discounts on securities and loans as well as the amortization of other deferred charges was not in accordance with Generally Accepted Accounting Principles ("GAAP").

Specifically, the Enterprise's method of recording adjustments for the difference between the cumulative life-to-date amortization (which was based upon the previous estimated lives) and what that amortization should be (based upon current estimated lives of the underlying mortgage assets) does not comply with the requirements of Statement of Financial Accounting Standards Number 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (SFAS 91). The Enterprise's determination of prospective amortization also does not comply with GAAP.

SFAS 91 is highlighted as a critical accounting policy in the Enterprise's 2003 Form 10K filed with the Securities and Exchange Commission. The MD&A section of the Form 10K details Fannie Mae's underlying application of amortization as it relates to SFAS 91, and also explains that the accounting estimates associated with amortization of deferred price adjustments are "critical accounting estimates."

Despite its importance to the Enterprise's financial statements and despite the requirement to formulate best estimates in good faith, Fannie Mae intentionally developed accounting policies, and selected and applied accounting methods, to inappropriately reduce earnings volatility and provide management with the flexibility to determine the amount of income and expense recognized in any accounting period. In this regard, Fannie Mae developed policies and methods to create a "cookie jar" reserve. More specifically, management of the Enterprise:

- Failed to apply the accounting treatment required by SFAS 91 to REMIC[1] securities held in its portfolio until 1998, even though SFAS 91 became effective in 1988.
- Inappropriately deferred $200 million of estimated expense in 1998, and established and executed a plan to record this expense in subsequent fiscal years. Furthermore, the deferral of such amount enabled management of the Enterprise to receive 100% of their annual bonus compensation. Without such deferral, no bonus would have been paid out.
- Undertook a concerted effort to develop and adopt accounting policies that would enable the Enterprise to spread income or expense over multiple reporting periods.
- Applied a materiality threshold to estimated income and expense, within which the Enterprise could avoid making adjustments that would otherwise be required under SFAS 91.

[1] Real Estate Mortgage Investment Conduit, as defined by Barron's Dictionary of Finance and Investment Terms 2003, is a pass through vehicle created under the Tax Reform Act of 1986 to issue multi-class mortgage backed securities.

- Made discretionary adjustments to the financial statements, for the sole purpose of minimizing volatility and achieving desired financial results.
- Forecasted and managed unrecognized income and expense to measure and maintain a "cookie jar" reserve.
- Recorded reconciliation differences and other errors as 'phantom assets and liabilities'. These phantom assets and liabilities were then amortized in accordance with a 30-year conventional mortgage proxy life.
- Developed estimation methods that were inconsistently applied to retrospective and prospective amortization.
- Applied discretion to the selection of market rate assumptions in order to achieve desired accounting results.
- Developed and effected capabilities to iteratively generate and evaluate estimates under varying assumptions, in order to obtain desired outcomes.
- Incorrectly and inconsistently applied adjustments to the estimate of amortization.
- Failed to properly investigate an employee's concerns regarding illogical or anomalous amortization results, and allegations of an intent to misstate reported income.
- Tolerated significant weaknesses in internal controls that undermined control objectives, maintained inadequate segregation of duties, and impeded the review and oversight of accounting processes and results.

Requirements of SFAS 91

SFAS 91[2] was issued to establish consistent accounting for nonrefundable fees and costs associated with lending activities. The scope of SFAS 91 includes premiums, discounts, and other deferred purchase and guarantee fee price adjustments (collectively "deferred price adjustments"), and requires that they be recognized as an adjustment to income using the effective yield method. This method requires that a company estimate a constant effective yield for (e.g., loans and mortgage-backed securities (MBS)) each time a company reports its financial results.

The accounting standard requires that purchases of loans and MBS be recorded at the net purchase price, taking into account premiums, discounts and other deferred purchase and

[2] Statement of Financial Accounting Standards No. 91 Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, effective December 1988.

guarantee fee price adjustments.[3] These price adjustments are recognized as an adjustment of yield over the life of the loan or security. In determining an estimate of the appropriate adjustment of yield, a company would need to consider the anticipated rate of prepayment for the associated loans and securities to the extent they are subject to prepayment.[4]

In addition, if a difference arises between the prepayments anticipated and the actual prepayments experienced, the effective yield must also reflect the actual payments to date, and a new estimate of anticipated future payments needs to be made. The difference between the revised estimate of amortization and the actual recorded amortization is required to be booked as an adjustment to interest income immediately. SFAS 91 also requires disclosure of anticipated prepayments and significant assumptions underlying the prepayment estimates.

The key phrase in the guidance for SFAS 91 is the term "constant effective yield." This means, for instance, assuming no changes in the estimated life of an instrument, that the effective yield on an investment would be the same for each reporting period in the life of the instrument. The guidance on this process is also provided by SFAS 91 as follows:

> Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise[5] holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may[6] consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method[7] and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. **The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income.** [Emphasis added] Enterprises that

[3] Guarantee fee price adjustments include "buy-ups" – negotiated up-front cash disbursements from the Enterprise to lenders in return for a higher Enterprise guarantee fee, and "buy-downs" – up-front cash receipts from lenders in return for a lower Enterprise guarantee fee.
[4] A mortgage is typically subject to prepayment. Most of the loans and securities held by Fannie Mae are mortgage related and therefore are subject to prepayment.
[5] In this context enterprise is used generically and does not refer specifically to Fannie Mae.
[6] Alternatively, if an enterprise chooses *not* to use estimates of prepayments, the amortization period could be the contract period (e.g., loan term). However, if the contract period is used, large spikes in amortization could occur if the amortization period is shortened due to prepayment. For instance, if a loan prepaid early, all of the unamortized amounts would have to be immediately recognized in the income statement.
Because mortgages and mortgage-backed securities generally can be prepaid at any time, using the contract period could lead to significant fluctuations in amortization (for instance if rates fall precipitously and prepayments speed up due to refinancing) which makes this an unpopular option.
[7] "Interest Method" is terminology that also refers to the method for determining a constant effective yield.

> anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates.[8]

Thus, as time passes, new estimates of the estimated life of an instrument can be developed, and the amount of amortization needs to be changed both *retrospectively* (that is what is meant by the guidance above which states in part, "adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans") and *prospectively* (by changing the rate of amortization going forward).

The accounting guidance on how to estimate prepayments for purposes of calculating interest amortization is provided in question 52 in the Q&A on SFAS 91[9]:

> Q--If a lender meets the requirements of paragraph 19 for considering principal prepayments in calculating constant effective yield, what factors should be considered in estimating those principal prepayments?
>
> A--The lender should consider historical prepayment data in making its estimate of future prepayments. Also, the lender should consider external information, including existing and forecasted interest rates and economic conditions and published mortality and prepayment tables for similar loans. If periodic changes in estimates occur or actual prepayments are different from estimated prepayments, an adjustment will be necessary.

In a large mortgage portfolio, the accounting for amortization could lead to significant volatility for two reasons:

- SFAS 91 requires that adjustments should be recorded into income when the estimated amortization period changes. This is significant because the amount of such adjustment is a *cumulative life-to-date* amount.
- The estimated life of a mortgage loan or mortgage-backed security fluctuates constantly due to changes in interest rates, changes in forecasts of prepayments and other factors.

In subsequent sections of this report we will demonstrate how Fannie Mae established an amortization policy that would allow the Enterprise to avoid current period volatility, and would further provide management with the latitude to shift income and minimize the potential for prospective volatility.

A hypothetical example of the application of SFAS 91 was provided to the Audit Committee of the Board of Fannie Mae on November 17, 2003 by Ms. Leanne Spencer, SVP Controller.[10] The

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[8] SFAS 91, Application of the Interest Method and Other Amortization Matters, paragraph 19.
[9] "A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers", published by the FASB
[10] Fannie Mae Audit Committee Update, Critical Accounting Policy, Deferred Price Adjustments, by Leanne Spencer, November 17, 2003, FMSE 015610-015623
It should be noted that, pursuant to SFAS 91, prepayment can only be forecasted for a pool of loans. A single security has been used for this illustration as an example only.

example is based upon a $100,000 loan that is purchased at a 2% discount. The discount of $2,000 would be recorded as additional interest income over the estimated life of the loan with an offsetting increase to the recorded amount of the loan.

Table 1 of the example below shows how the constant effective yield method of amortization would translate into amortization of the discount over the originally estimated life of the loan.

Table 2 of the example is based on an assumption that at the end of the fifth year the estimated life of the instrument is shortened from 10 years to 7 years. This table shows what the amortization would have been if the estimated life of the instrument had *originally* been estimated to be 7 years. The difference between the two "Inception to-date" amounts of amortization at the end of the fifth year is the amount of income to be recognized ($1,587-$1,400 = $187). In addition, the future amortization periods in table 2 show that there are only two more years of amortization to be recorded, and that the amounts to be recorded (in years 6 and 7) have been adjusted accordingly.

Table 1

Original Est. Life	Discount Amortization	Inception to-date	Effective Yield
1	$333		6.4618%
2	$308		6.4618%
3	$282		6.4618%
4	$254		6.4618%
5	$224	$ 1,400	6.4618%
6	$192		6.4618%
7	$158		6.4618%
8	$122		6.4618%
9	$84		6.4618%
10	$43		6.4618%

Table 2

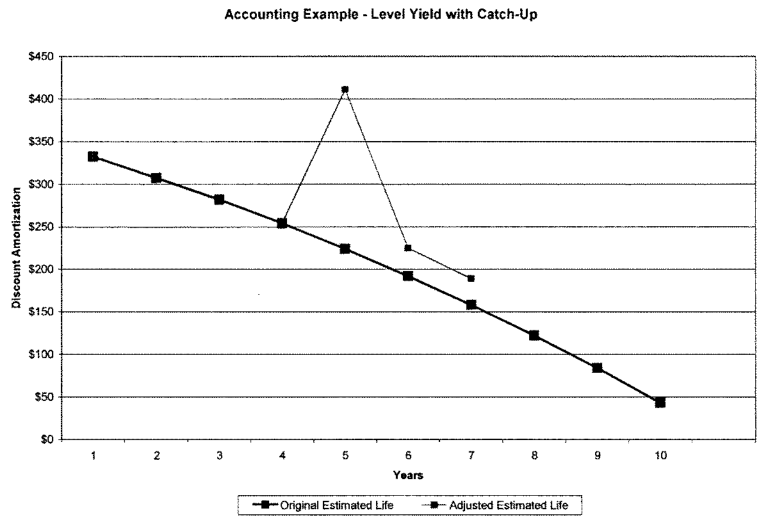
Adjusted Est. Life	Adjusted Discount	Inception to-date	Effective Yield	Inception to-date adjustment
1	$373		6.5030%	
2	$347		6.5030%	
3	$319		6.5030%	
4	$290		6.5030%	
5	$258	$1,587	6.5030%	$187
6	$225		6.5030%	
7	$189		6.5030%	

Presentation to Fannie Mae Audit Committee: Critical Accounting Policy, Deferred Price Adjustments, by Leanne Spencer dated November 17, 2003, FMSE 015610-015623

The $187 in this example is calculated as the difference between the cumulative life-to-date amount of interest amortization of $1,400 (what was already recorded based upon a previous estimated life of 10 years) and what the amortization should be: $1,587 (based upon the new estimated life of 7 years).

As mentioned previously, SFAS 91 requires that the amount of amortization income or expense for prior periods caused by a change in the set of assumptions be recorded into income *immediately* (in this example $187 needs to be recorded at the end of year 5).

We have used the information in the tables above to chart the effect that this would have on the discount amortization:



As the graph above shows, the recording of the $187 of retrospective amortization in the year that the estimated life is shortened from 10 years to 7 (in this case year 5) significantly increases the volatility of the amount of amortization. OFHEO has concluded that this is exactly the type of volatility that Fannie Mae was trying to avoid in designing their amortization policy.[11]

[11] OFHEO Interview, Ms. Janet Pennewell, VP Financial Reporting & Planning, June 15, 2004, pp. 16-18
Q: What is arbitrary volatility in earnings?
A: Arbitrary volatility, in our view, was introduced when--I can give you an example of what would cause, in our view, arbitrary volatility. If your constant effective yield was dramatically different between one quarter and the next quarter because of an arbitrary decision you had or view--changing your view of long-term interest rates that caused a dramatic change in the constant effective yield that you were reporting, you could therefore be in a position where you might be booking 300 million of income in one quarter and 200 million of expense in the next quarter, introduced merely by what your assumption about future interest rates was. And to us that was arbitrary volatility because it really just literally because of your view, your expectation of interest rates and the way that you were modeling your premium and discount constant effective yield, you would introduce something into your financial statements that, again, wasn't very reflective of how you really expect that mortgage to perform over its entire expected life, and was not very representative of the fundamental financial performance of the company.
OFHEO Interview, Mr. Tim Howard, EVP Chief Financial Officer, August 5, 2004, pp. 120-121
Q: Do you have a specific understanding of the individual that approved this policy for the company?
A: Well, again, it would have been Jonathan Boyles who would have been our subject matter expert. Leanne technically approved it as the Controller, and I concurred. KPMG also reviewed this and opined that it was GAAP.
Q: So, specifically, this policy was recommended by Jonathan Boyles?
A: I'm not sure who recommended it. I was involved in the development of the policy. There was a lengthy process where we looked at many different ways to deal with the fact that estimating the life of a

Special Examination of Fannie Mae
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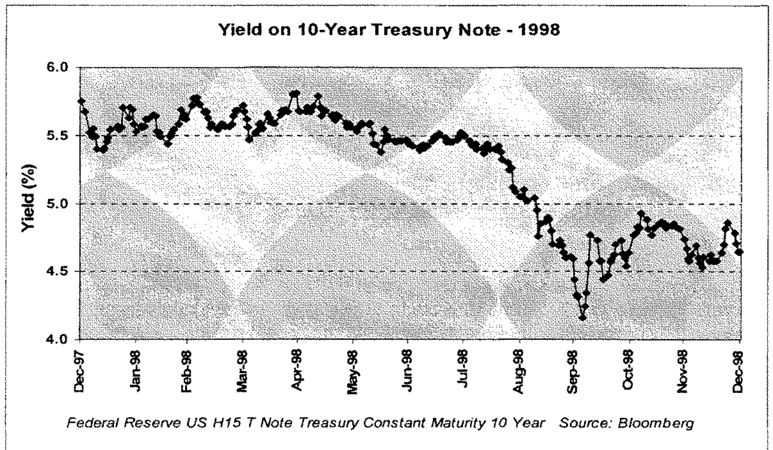
Policy and Infrastructure Development

Events of 1998 and 1999

Fourth Quarter of 1998
The genesis for many of Fannie Mae's philosophies, policies and methods began at a time of financial stress for the American economy. In the third quarter of 1998, the Russian Financial Crisis (among other things) caused dramatically lower interest rates. The resulting interest rate environment increased the propensity of consumers to prepay their existing home mortgages and refinance them at more favorable rates.

The following chart illustrates the dramatic shift in rates during 1998:



The manifestation of faster prepayments adversely impacted the Enterprise. The impact of changing rates of prepayments on deferred price adjustments is a function of cumulative life to date amortization itself, and whether prepayment rates are increasing or decreasing, and whether aggregate premiums are greater or lesser than aggregate discounts with respect to the associated loans and securities.[12] Since prepayments were increasings, Fannie Mae's amortization models showed that an estimated expense of approximately $400 million had been incurred. This estimated expense was the adjustment necessary to recognize the impact of

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mortgage has inherent uncertainties, and we wanted to come up with a policy that was consistent with GAAP, that minimized the potential for introducing unnecessary volatility based on what, to me, would have been arbitrary assumptions that would change substantially over time and therefore not be reflective of the economic substance of the transactions being accounted for.

[12] Faster prepayments generally result in losses for a portfolio where aggregate premiums exceed aggregate discounts, and gains where aggregate discounts exceed aggregate premiums. Slower prepayments have the opposite affect.

changing prepayments on deferred price adjustments, consistent with the constant effective yield calculation required under GAAP. **Rather than recognizing the full amount of this estimated adjustment to income, Enterprise management decided to defer recognizing approximately one half (or $200 million) of the estimated expense.**[13] The $200 million was known within the Enterprise as the "*catch-up*". In both previous and subsequent reporting periods, differences between amounts estimated versus the amount previously recorded, were consistently referred to within the Enterprise as the catch-up. OFHEO has further concluded that Fannie Mae's methods for determining the catch-up were also inconsistent with the requirements of SFAS 91.

As described throughout this report, OFHEO has concluded that there a variety of reasons why the "catch-up" calculation ***would not*** produce results similar to those required by the retrospective adjustment required by SFAS 91. However, the term "catch-up" is used throughout this report in order to provided context and factual information related to the preliminary results of our examination.

In their testimony, management explained that the deferral of this expense was necessitated by limitations in models and insufficient infrastructure that caused the estimate of expense to be overstated. However, the Enterprise has not provided OFHEO with any credible analysis[14] which supports the recording of only half of the calculated catch-up amount. In fact, information received during the examination directly contradicts the explanations which management provided. Both Ms. Leanne Spencer, Controller, and Mr. Tim Howard, Chief Financial Officer indicated that one of the reasons for not recording the additional $200 million of amortization expense related to the fact that not all REMIC securities could be modeled individually.[15] In contrast, records provided to OFHEO indicate that, upon increasing the

[13] OFHEO Interview, Ms. Leanne Spencer, June 22, 2004, pp. 34-36
Q: What was the potential impact of the 200 million difference on earnings?
A: I would like to give you some background on 1998 –
Q: Sure.
A: [...] By the end of the year--by the end of the year, as we moved to the end of the year, we took an adjustment of over $200 million into our financial--into our financial statements. We had a remaining balance of approximately 200 million which our auditors were very comfortable with. We were very comfortable with. [...]
[14] Memorandum from Mr. Jeff Juliane to Ms. Leanne Spencer, Subject: Income Risks from Amortization Issues, dated July 14, 1999, FMSE-SP 003103.
[15] OFHEO Interview, Mr. Tim Howard, August 5, 2004, pp. 211-212
Q: You mentioned the inadequacy in the system or your ability to deal with the REMIC at the time. What's the relevance of that to the determination of the catch-up adjustment in '98?
A: We believed that the REMIC book – that the expense that needed to be booked to reflect expected amortization in the REMIC book was overstated based on the inadequacies of the system. We were in the process of undertaking a project to do loan level detail, or at least security class level detail of the REMIC book. And as we completed that, our basic instinct on the nature of that book turned out to be correct. And once we reflected that in actuals later on – don't know if it was '99; I think it was – that also proved out to be true. So that part was factually verified. The rest was situational.
OFHEO Interview, Ms. Leanne Spencer, June 22, 2004, pp. 34-37
Q: What was the potential impact of the 200 million difference on earnings?
A: I would like to give you some background on 1998 –
Q: Sure.
A: In 1998, particularly as relates to the second half of the year, interest rates were extremely volatile. You had global economic meltdown occurring, Russian financial crisis, so you had a very precipitous drop

percentage of REMIC securities which could be modeled, the amount of the catch-up expense amount actually *increased*.[16]

Lastly, in performing their audit of the Enterprise's 1998 financial statements, Fannie Mae's independent auditor, KPMG, identified the $200 million deferred expense (the unrecorded amount) as an audit difference.[17]

Despite their insistence that the estimate of loss was overstated, Fannie Mae management nevertheless developed a strategy to record planned monthly on-top adjustments[18] to the financial statements to recognize the estimated $200 million deferred expense in the subsequent fiscal years 1999 and 2000.[19]

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in interest rates that occurred with a significant – significant effect on business was that you had a significant amount of prepayment occurring. So, this is what you had going on in the world. We found ourselves in a company at that point in time where our balances on our balance sheet as it relates to the portfolio, rates have been fairly stable. You moved into a big period of rate move, and we had a model at that point in time that had been developed, predated my involvement in the Controller's Department, but it was an early generation model that had been built to implement FAS 91, and it had limitations now for this period of time in terms of how the business had grown, how – how the business had grown, volatility in rates, the limitations that would even allow you to put good robust assumptions into it. So, it's the kind of second piece that we were dealing. And then there is a third piece relevant to this that we were dealing with as a company, in that we had some asset classes that had been had been allowed to be purchased for the portfolio, gone through all the pertinent reviews in terms of allowing the portfolio to begin to purchase REMIC to hold as an investment – as an investment class. We had good controls on the front end in terms of who could evaluate them and price them appropriately. We didn't have sufficient – we didn't have a sufficient infrastructure on the back end and in the model to be able to do a pristine FAS 91-type level yield calculation on this asset class, although it was something that we were working toward. So, there was a set of factors that were occurring in 1998. [...]

[16] Fannie Mae PDA Catch-Up, FMSE-SP 000471. Note 2 to the analysis indicates that the amount of the catch-up expense on REMICS increased in June of 1999 by approximately $60 million from the prior month. Note 2 reads "Increased percent of REMIC book modeled." Such increase in the percent of the REMIC book modeled was corroborated by the testimony of Jeff Juliane on August, 31, 2004.
OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 245-246
Q: Now there's a Footnote 2 that relates to June of 1999 for the REMIC portfolio that indicates increased percent of REMIC book modeled. What does that refer to?
A: With [sic. What] that means is that prior to that, there were issues with getting cash flows passed back from Intex to the model, so that we were only modeling about 74 percent of all REMIC securities. And then when we – I think we increased it to approximately 90 percent at that point in time.
Q: And this increased the amount of negative catch-up?
A: Correct.

[17] OFHEO Interview, Ms. Leanne Spencer, SVP Controller, June 22, 2004, pp. 33-34
Q: Do you recall the nature of the premium discount amortization audit difference identified by KPMG?
A: Yes.
Q: Do you recall the amount?
A: Yes.
Q: And what was the amount?
A: Approximately 200 million.

[18] "On-top adjustments" represent adjustments made directly to the general ledger during the financial statements close process.

[19] OFHEO Interview, Ms. Janet Pennewell, VP Financial Reporting & Planning, June 15, 2004, pp 149-150

Beyond the $200 million deferred estimated expense itself, the explanations provided by management, as well as documents provided to OFHEO, raise other issues. First, if one accepted the Enterprise's rationale of estimation inaccuracy that existed at the end of the fourth quarter of 1998, then what about previous quarters? Information obtained by OFHEO shows that catch-up amounts were calculated as far back as 1995.[20] Furthermore, the catch-up exceeded $100 million as early as December 1996, and further exceeded $150 million for each of the three quarters prior to the fourth quarter in 1998.[21] Consistent with managements explanation, the incremental effect to the catch-up does indeed appear to arise in the fourth quarter 1998; however, it seems to arise because that time period is the first time period in which *any* calculation of catch-up for REMIC's was performed.[22] **This information as well as other documentation[23] seems to indicate that the calculation of constant effective yield for REMIC securities had not previously been performed at all, even though SFAS 91 became effective in 1988.**

The second issue raised is one concerning the nature of the catch-up itself. This issue will be further examined in subsequent sections of this report.

Bonuses Awarded in 1998

Fannie Mae compensation for executive officers involves several key components: 1) basic compensation, which includes base salary and other annual compensation; 2) Annual Incentive Plan (AIP) awards ("bonuses"), which link the size of the bonus pool to meeting annual earnings per share (EPS) goals; and 3) long-term incentive awards, which typically award substantial amounts of "performance shares" to executives if EPS and certain non-financial goals are met over a three-year period.

The Fannie Mae proxy statement for 1998 disclosed salary and annual bonuses to certain senior executives as follows:

Q: [...] you had testified that in December of 1998 that you had experienced losses due to the changes in the interest amortization, but at that point there was an approximately 200 million catch-up that was a negative catch-up, correct?
A: That's my recollection, yes.
Q: A negative catch-up would be a deferred expense, correct?
A: Correct.
Q: Now, you indicated that there had been discussions with KPMG and there was an objective to try to cut that in half. And was the objective to try to cut that in half in one year or over a two-year horizon, or do you recall any time—
A: My recollection is over one year.
Q: Okay. Now, was that achieved through systematic, planned on-tops, or was it offset against other changes in the catch-up?
A: It was primarily--it was primarily achieved through a systematic, planned on-tops, but then in addition to those planned on-tops, we re-evaluated our catch-up position each quarter to see if either the composition of the book premium discount or changes in interest rates would have altered our position.

[20] Analysis document titled "Fannie Mae PDA Catch-up", dated October 6, 2000, FMSE-SP 002434.

[21] *Id.*

[22] *Id.*

[23] Memorandum from Mr. Jeff Juliane to Ms. Leanne Spencer, Subject: Income Risks from Amortization Issues, dated July 14, 1999, FMSE-SP 003103.

1998 Salary and Bonus of Senior Fannie Mae Executives

Officer	Title	Salary	AIP Award/Bonus
James A. Johnson	Chairman and CEO	$966,000	$1,932,000
Franklin D. Raines	Chairman and CEO Designate	$526,154	$1,109,589
Lawrence M. Small	President and COO	$783,839	$1,108,259
Jamie Gorelick	Vice-Chairman	$567,000	$779,625
J. Timothy Howard	EVP and CFO	$395,000	$493,750
Robert J. Levin	EVP, Housing and Comm. Develop.	$395,000	$493,750

Source: Fannie Mae Notice of Annual Meeting of Stockholders, May 20, 1999

1998 Earnings Per Share Targets
Fannie Mae adopted EPS thresholds for annual bonuses in 1995 partly to bring that short-term, performance-based compensation measure into conformity with their long-term compensation plan, which was already EPS-based.[24]

For the year-ended 1998, the size of the annual bonus payout pool was linked to specific EPS targets, as follows: [25]

Earnings Per Share (EPS) Range for 1998 AIP Corporate Goals

$3.13 Minimum Payout
$3.18 Target Payout
$3.23 Maximum Payout

For Fannie Mae to pay out the *maximum* amount in AIP awards in 1998 (approximately $27.1 million), the Earnings Per Share would have to be $3.23. If EPS was below the $3.13 minimum payout threshold, no AIP payout would occur. Remarkably, the 1998 EPS number turned out to be $3.2309, a result that meant that Fannie Mae met the EPS maximum payout goal right down to the penny.

Impact of 1998 Catch-up on Compensation
The annual EPS number is determined by dividing the net annual earnings by the average number of shares of common stock outstanding for the year. Accordingly, the 1998 $3.23 EPS was derived by dividing the net income available to common shareholders ($3.352 billion) by the weighted average number of common shares outstanding (1,037 million).[26]

Notably, had net income available to common shareholders been reduced by $125 million, the EPS for 1998 would have fallen to $3.11[27]--below the minimum payout threshold. As a result,

[24] FMSE 017772.
[25] *Id.*
[26] These figures include dilutive potential common shares. Fannie Mae 1998 Annual Report, Financial and Statistical Summary, p. 51.
[27] $3.227 billion of earnings ÷ 1,037 million shares

no bonuses would have been awarded. Alternatively, had net income been reduced even a relatively modest $50 million, the EPS would have been approximately $3.18.[28] In that instance, the overall bonus pool would have been reduced by approximately $9 million to $18 million. This would have resulted in a corresponding reduction in bonuses awarded to individual executive officers.

As it turns out, the unrecognized estimated $200 million negative catch-up was a pre-tax effect on net income. Adjusted for taxes at the 35% statutory federal corporate income tax rate,[29] the after tax impact on net income – upon which calculations of EPS are made - was approximately $130 million. **The tax affected amount of deferred expense therefore, only slightly exceeded the $125 million difference between no bonus being awarded and the maximum amount being awarded.**

Recognition of 1998 "Catch-up" in 1999

In 1999, the Enterprise began to record the scheduled on-top adjustments to recognize the $200 million negative catch-up.[30] The objective of the plan was to recognize amounts sufficient to ensure that the catch-up did not exceed negative $100 million at the end of fiscal year 1999.[31] Accordingly, the Enterprise determined to record monthly on-top adjustments to recognize estimated losses of $5 million and $2.9 million to Net Interest Income ("NII") and deferred price adjustments (in internal documents Fannie Mae refers to these adjustments collectively as "GFee", and this report adopts that convention) respectively.[32] In addition to these planned on-tops however, the Enterprise also decided, during the course of the year, to write-off an additional $95 million "against NII as a reserve against future interest rate changes."[33] This additional $95 million write-off was also scheduled monthly, such that the planned aggregate monthly adjustment to NII and GFee ultimately grew to $16.5 million.[34]

Such amounts are described in a July 1999 analysis. The analysis shows the actual adjustments recorded to amortization as of June 1999 and the amount of forecasted adjustments through the remainder of the year. The analysis clearly shows that the Enterprise had developed a plan to systematically record the $16.5 million of adjustments per month. It should be noted that $16.5 million per month for twelve months totals to planned adjustments of $198 million. This amount of planned adjustments is almost identical to the amount of catch-up not recorded as of the end of 1998.

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[28] $3.302 billion of earnings ÷ 1,037 million shares

[29] Fannie Mae 1998 Annual Report, pp. 50-51, Notes to the Financial Statements, Note 6: Income Taxes. Further pursuant to this footnote, Fannie Mae is exempt from state and local income taxes.

[30] OFHEO Interview, Ms. Leanne Spencer, SVP Controller, June 22, 2004, pp. 55-56

Q: Now, in 1999, did you make scheduled adjustments as a result of the 200 million that was determined at the end of 1998?

A: Yes.

[31] Fannie Mae Controller, Leanne Spencer, acknowledged the reason for this objective. OFHEO Interview, Ms. Leanne Spencer, June 22, 2004, p. 56.

Q: Now, it is our understanding that, in fact, KPMG was desirous of reducing that 200 million to a hundred million at least by the end of '99; is that consistent with your recollection?

A: It's consistent with my recollection.

[32] Monthly Summary of Amortization Adjustments, July 14, 1999, FMSE-SP 003102

[33] *Id.*

[34] *Id.*

In addition, in the notes to the aforementioned analysis, the following explanation is provided for the planned on-tops:

> Note- Per plan, a write-off of $95 million was to be taken to reduce our catchup [sic] in a systematic approach of $5 million a month for NII and $2.9 million a month for Gfee. Subsequent to plan, an additional $95 million was to be written-off [sic] against NII as a reserve against future interest rate changes.[35]

As the note above shows, not only was the $200 million amount of catch-up that was deferred being recorded into the income statement in a systematic manner, but a portion of it was specifically referred to as a "reserve against future interest rate changes." This note is the earliest indication that the Enterprise specifically intended to manage the catch-up position as a buffer to sudden changes in interest rates and the resultant volatility of amortization amounts. **The lesson the Enterprise learned in 1998 was clear: avoid having to record large amounts of unexpected catch-up expenses by actively managing the process of calculating amortization.**

But subsequent increases in interest rates overtook Fannie Mae's plans. At the same time that the Enterprise was recording the monthly on-top adjustments, a rise in interest rates was having a favorable economic impact on Fannie Mae's catch-up position. OFHEO was not able to determine the exact amount of planned NII and GFee on-top adjustments that were actually recorded during the year 1999.[36] However, through the combination of on-top adjustments that were recorded and the changing economic environment, the amount of unrecognized catch-up had actually become a positive (deferred credit) amount of $84 million[37] by the end of 1999.

Formulation and Adoption of Accounting Policy

Formulation of Accounting Policy
During 1999 Fannie Mae management also began a prolonged and concerted effort to formulate a policy to manage the amortization of deferred price adjustments. **Many of the policies considered, as well as those subsequently adopted, were inconsistent with GAAP, and were designed to provide earnings flexibility and minimize earnings volatility.**

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[35] *Id.*
[36] An analysis of the catch-up position prepared by the Enterprise would seem to indicate that the amount of recorded adjustments was $158.0 million ($136.3 million through on-top adjustments, and $21.7 million applied as amortization factor change adjustments). Fannie Mae PDA Catch-up, April 10, 2000, FMSE-SP 000505.
[37] OFHEO Interview, Ms. Leanne Spencer, SVP Controller, June 22, 2004, p. 53
Q: And then you indicated at the end of 1999 they identified another audit difference that I believe was really the reversal of the $200 million effect, or was it something different?
A: No, I would describe that as different. I will kind of go back to time doesn't stand still, and as you do 365 or how many business days you have during your start, you're starting with a balance, you're rolling forward, rates are changing, prepayments are changing, new business coming on--is coming on in a different mix. So, there is a variety of factors that affects your recalibration and your reestimation process. But by the end of the year, it was $84 million positive.

The effort was directed and overseen by Chief Financial Officer Mr. Tim Howard. Policy analysis was performed for the most part by personnel within the controllers group, including active involvement by the Controller, Ms. Leanne Spencer. Mr. Tom Lawler, Senior Vice President Portfolio Management,[38] was also part of the policy analysis team. Beginning in the first quarter of 1999 and continuing throughout 2000 numerous memoranda regarding SFAS 91 policy recommendations were developed. Many of these memoranda expressed – as an objective of policy formulation - the need to minimize the volatility of reported earnings. Certain of these memoranda acknowledged the flexibility provided by the policies and methods proposed.[39]

The specific recommended policy provisions within these memoranda varied as to their precise nature, and the empirical thresholds that would be applied. However, certain themes were consistently reflected within them, including policy recommendations that permitted the Enterprise:

a. **to not recognize estimated income or expense up to certain thresholds, and**

b. **to defer the recognition of income or expense that exceeded recommended thresholds over a several year planning horizon**

Such accounting methods are neither supported by SFAS 91 nor Generally Accepted Accounting Principles more broadly. However, provisions of this nature were ultimately adopted as policy by the Enterprise in December of 2000.[40]

One memorandum, dated September 23, 1999, proposed that estimated income be treated differently than estimated expense. [41] In the case of estimated income, no adjustment to

[38] Mr. Tom Lawler was Senior Vice President of Portfolio Management at the time the policy analysis team was functioning. In 2002, Mr. Tom Lawler was designated Senior Vice President of Corporate Financial Strategy. OFHEO Interview Mr. Tom Lawler, June 24, 2004, pp. 7-9.
[39] Memorandum from Ms. Janet Pennewell, Vice President Financial Reporting, and Mr. Jeff Juliane, to Mr. Tim Howard, December 16, 1999, Subject: Catch-up Policy. FMSE 217559 -217561.
One of several reasons provided for recommending a method of modeling the catch-up reads: "3) Due to system enhancements and increased analytics, we will be better positioned to forecast future catch-up behavior. This should provide the flexibility to adhere to a much more stringent standard while minimizing material catch-up swings recently experienced. This policy acknowledges such changes and additionally maintains a cushion for income statement flexibility."
Attachment to email from Mr. Tim Howard, CFO, to Ms. Janet Pennewell, SVP Financial Reporting and Planning, November 25, 2000, Subject; Amortization. Pennewell 08182004
A paragraph describing the proposed amortization strategy reads: "Today's configuration would give us a fair amount of leeway under the policy I envision. We start out under our plus or minus $75 million range, so technically we wouldn't have to do anything for at least the first year. However, if we wanted to 'get a leg up' on getting under the $75 million threshold three years out we could certainly justify getting started today. Our policy would allow us to do $40 or $50 million this year-or even more. (I wouldn't recommend it, but we would have the flexibility to do so)."
[40] Purchase Premium and Discount Amortization Policy, December 2000, FMSE 074523-074524
[41] Memorandum from Ms. Janet Pennewell, VP Financial Reporting & Planning, to Mr. Tim Howard, CFO, September 23, 1999, Subject: Policy on Purchase Premium/Discount Management, FMSE-SP 000106-000107.

income would be taken if current interest rates were more than one standard deviation above the 5 year historical average. Other memoranda dated May 4, 2000[42] and May 8, 2000[43] proposed that adjustments be determined by comparing the estimated catch-up to the calculated annual on-top adjustment. Both memoranda recommended that the estimate of quarterly catch-up be given different treatment depending on whether the calculated estimate was positive or negative.[44] There is also no basis in SFAS 91, or in any promulgated accounting standard, that would support any of these accounting treatments recommended by management.

Policy Adopted to Recognize Expense or Income Over Multiple Reporting Periods
The first memorandum[45] that proposed a recommended accounting policy on the catch-up position was dated March 2, 1999, and was from the Controller to the Chief Financial Officer. This memorandum recommended that adjustments only be required in the current year, if the catch-up position exceeded +/-3.5% of projected annual revenue. Otherwise, management would implement a plan to bring the balance down to 2% of annual revenue by the end of the *following* year. Coincidentally, this threshold approximated the $200 million amount of estimated expense not recognized just two months prior.[46] The previously referred to memorandum[47], dated September 23, 1999, alternatively recommended applying a similar $200 million threshold, but characterized it instead as 1% of *three* year cumulative revenue.[48]

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[42] Memorandum from Mr. Jeff Juliane, Director Financial Accounting, to Distribution, May 4, 2000, Subject: Amortization/Catch-up Management Process, FMSE 217540.
[43] Draft Memorandum from Mr. Jeff Juliane to Distribution, May 8, 2000, Subject: Amortization/Catch-up Management Process, FMSE 217527. This draft memorandum was subsequently distributed as an attachment to a memorandum dated September 15, 2000 from Ms. Janet Pennewell to Mr. Tim Howard, Subject: Amortization Policy. In this distribution, the label "Draft" had been removed from the memorandum.
[44] Memorandum from Mr. Jeff Juliane to Distribution, May 4, 2000, Subject: Amortization/Catch-up Management Process, FMSE 217540-217544, states that "In any interim year, if the mean catch-up is less than the calculated annual on-top, the amount of on-top applied in that year will equal the mean catch-up. If the mean catch-up is the opposite sign as compared to the calculated on-top, no adjustment will be made.
Draft Memorandum from Mr. Jeff Juliane to Distribution, May 8, 2000 (with a handwritten note saying "draft for meeting with Tim on May"), FMSE 217527-217528, describes under "Catch-up Recognition" how the Enterprise plans to reach their "targeted catch-up": "A. If the spot estimate exceeded 2.5% of pre-tax income, we would accelerate the on-tops to ensure that we were less than the 2.5% target within 1 year. B. If the spot estimate exceeded 5% of pre-tax income, an immediate on-top adjustment would be taken to bring us within the 5% limit. C. If the spot estimate for any interim year is less than the calculated annual on-top, the amount of on-top applied in that year will equal the spot estimate. D. If the spot estimate is the opposite sign as compared to the calculated on-top, no adjustment will be made." OFHEO received this document in a final version labeled FMSE-SP 000019-000020.
[45] Memorandum from Ms. Leanne Spencer and Ms. Janet Pennewell to Mr. Tim Howard, Subject: Policy on Purchase Premium/Discount Management, March 2, 1999, FMSE-SP 000110-000111.
[46] *Id.*, The actual recommendation stated; "If the Catch-up exceeds 3.5% of projected annual revenue (currently about $200 million) we will take a write-off during the current calendar year to bring it below that level, and will implement a plan to bring the balance down to 2% of projected revenue by the end of the following year."
[47] Memorandum from Ms. Janet Pennewell to Mr. Tim Howard, September 23, 1999, Subject: Policy on Purchase Premium/Discount Management, FMSE-SP 000106-000109
[48] *Id.*

Subsequent memoranda proposed even higher thresholds before an immediate adjustment to earnings would be required. The previously referred to memoranda[49] dated May 4, 2000, May 8, 2000, and September 15, 2000, recommended that immediate adjustments not be required until 5% of annual pre-tax income had been exceeded. 5% of annual pre-tax income was, at the time, approximately $300 million. This is an extremely large threshold considering that during the three years for which OFHEO has data, the quarterly *combined* deferred price amortization never exceeded $142 million (FMSE 184911, 184994, 185079, 184923, 185006, and 185092).[50]

Furthermore, in theory, if such a 5% threshold had been applied, quarterly changes in catch-up of up to $600 million income statement impact (+/- $300 million) could go unrecorded in any given quarter. This too is also extremely large considering that the quarterly change in purchased premium/discount and guarantee fee amortization reported by the Enterprise in its financial statements never exceeded $135.8 million[51] and $127.4 million[52] respectively, in any of the quarterly periods for which OFHEO has such information.[53]

The subsequent memorandum that sought to recommend these higher thresholds also recommended that adjustments be made over a one year horizon of time to reduce the catch-up to below a +/- 2.5% (approximately +/- $150 million) threshold.

Ultimately, in December 2000, the Enterprise established a policy[54] that had two provisions addressing the recognition of larger variances in catch-up over multiple reporting periods. These provisions are:

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[49] Memorandum from Mr. Jeff Juliane to Distribution, May 4, 2000, Subject: Amortization/Catch-up Management Process, FMSE 217540, and Draft Memorandum from Mr. Jeff Juliane to Distribution, May 8, 2000, Subject: Amortization/Catch-up Management Process, FMSE 217527. This draft memorandum was subsequently distributed as an attachment to a memorandum dated September 15, 2000 from Ms. Janet Pennewell to Mr. Tim Howard, Subject: Amortization Policy. In this distribution the label "Draft" had been removed from the memorandum.

[50] Memoranda recommending accounting policy for deferred price amortization in 1999 and 2000 did not distinguish between purchased premium and discount amortization (which is recorded as a component of *Net interest income*) and guarantee fee amortization (which is recorded separately in the income statement as *Guarantee fees)*. Various Fannie Mae analyses prepared in conjunction with these memoranda, as well as early policy drafts (FMSE 217499), indicate that these combined amortization amounts would be applied when measuring against the applicable recommended threshold. The policy subsequently adopted in December 2000 (FMSE 074523) also specified that these components would be combined. However, the policy also stated *"Since the components of the total catch-up position are related to two different income statement line items, net interest income and Gfee, it is important to look at each component separately to determine whether an audit difference has occurred.* For the quarterly periods for which OFHEO has the relevant information (Q1 2001 through Q1 2004), the highest separate amounts of quarterly purchased premium/discount amortization and guarantee fee amortization were approximately $(151) million (FMSE 186045,186115, and 186186) and $244 million (FMSE 186053, 186123, and 186195) respectively.

[51] Change from Q4 2002 (FMSE 184911, 184994, and 185079) to Q1 2003 (FMSE 185164, 185244, and 185319).

[52] Change from Q4 2003 (FMSE 185835, 185907, and 185980) to Q1 2004 (FMSE 186053, 186123, and 186195).

[53] Q1 2001 through Q1 2004

[54] Purchase Premium and Discount Amortization Policy, December, 2000, FMSE 074523

i. If our catch-up moves beyond one, but within two percent of combined portfolio net interest and guarantee fee income, we will book monthly "on-top" adjustments that bring us back to within the plus or minus one percent range within our three year planning period.[55]

ii. Should our catch-up ever exceed two percent of the combined portfolio and interest guarantee fee income, however, we will bring it back to within the one to two percent range within a six month period. After that time, we will continue our monthly "on-tops" to return the catch-up to the plus or minus one year range within the three year horizon.[56]

That policy adopted in December 2000, remains the Enterprise's official policy today. In his testimony, Mr. Jonathan Boyles, Senior Vice President Financial Standards, acknowledged that these provisions were not consistent with GAAP.[57] Even though the estimated $200 million expense in 1998 was deferred and recognized in subsequent periods, Mr. Boyles and other senior officers explained that neither of the above two provisions were ever used since this policy was adopted in December 2000. However, it should be noted that the accounting treatment of the estimated $200 million expense in 1998 is similar (if not identical) to the same policies which Mr. Boyles stated would not be in accordance with GAAP.

Information gathered thus far in this Special Examination has not identified any instances since December 2000 where either of these two provisions had been used. However, we have identified other practices employed by the Enterprise whereby adjustments that should have been recognized immediately, were instead deferred and recognized over multiple reporting periods. [See section *Capitalization of Amortization of Reconciliation Differences* for a discussion of the Enterprise's treatment of "realignment" differences.]

Policy to Defer Income and Expense Up To Certain Thresholds

Management's drive to formulate policy in 1999 and 2000 was fueled by management's surprise at the magnitude of the $400 million estimated expense at the end of 1998, by a determination to avoid audit differences,[58] and by the insistence of KPMG[59] that a policy be developed. In

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[55] *Id.*

[56] *Id.*

[57] OFHEO Interview, Mr. Jonathan Boyles, August 24, 2004, pp. 12-13 (with respect to Exhibit 9A: Purchase Premium and Discount Amortization Policy, FMSE 074523-074524)

Q: The first sentence of this paragraph states: If our catch-up moves beyond one within two percent of combined portfolio net interest in guaranty fee income, we will book monthly "on-top" adjustments that bring us back to within the plus or minus one percent range within our three-year planning period. Is that a provision that you recollect discussing with the outside auditors, KPMG?

A: I don't recall discussing that provision.

Q: Is that a provision that you had approved at all?

A: I don't recall approving it.

Q: Okay. In your opinion is that provision permitted under General Accepted Accounting Principles?

A: No, I don't believe that would be allowed.

Q: Okay. In your opinion is that provision permitted under General Accepted Accounting Principles?

A: No, I don't believe that would be allowed.

[58] OFHEO Interview, Ms. Leanne Spencer, August 12, 2004, pp. 87-90

Q: Now my question is what basis does the company – did the company have when they established this policy for believing that adding a de minimis [sic. minimus] amount onto the target range was appropriate

addition to the policy provisions that would permit the Enterprise to recognize greater estimated income or expense over time, the Enterprise also recommended and ultimately adopted thresholds within which estimated income or expense would not be recognized at all. Indeed, such practice had already been an established part of the Enterprise's financial reporting, even prior to the 4th quarter of 1998. During 1998, Mr. Jonathan Boyles was the individual within the Enterprise responsible for determining the amount of the catch up position. In his testimony Mr. Boyles could not recall the catch-up ever being booked to zero during this timeframe.[60] In a memorandum dated November 25, 2000 from Mr. Tim Howard to Ms. Janet Pennewell, that discusses the elements of proposed policy, Mr. Howard notes that KPMG was comfortable with

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for GAAP? Was there some accounting standard or some understood practice within industry that would have provided that basis?

A: Are you asking – I'm just trying to be clear here so I can give you exactly what you need. Are you asking me why we considered a de minimis [sic. minimus] amount on top of the plus or minus 1 percent? This discussion occurred between Fannie Mae and KPMG at the same time that we were in discussions around what did or didn't constitute an audit difference. And what we were really trying to accomplish here with this document is to put things in writing and put things on paper so that we had an understanding and KPMG had an understanding of how we would operate in this framework. And so this was only put on here just for clarity and transparency. You probably know specifically – I can't recall, about the same time was there not a new – I don't know if it was an auditing standard or if it was an SEC standard, whereby all audit differences became a required part of conversations with the audit, you know, committee, or you know, this – you know where I'm going with this?

Q: Uh-huh.

A: And so what we were really trying to do, you know, I don't really like audit differences. I prefer not to have them. If there is something that needs to be corrected, I just want to post it.

Q: You wouldn't be the first company to have that feeling.

A: Pardon me?

Q: You wouldn't be the first company that had that feeling.

A: But that's how I feel. And so in a lot of putting this framework together, for our communication between Fannie Mae and KPMG to be very clear, and that we were going to operate within this policy, and I wasn't interested in having an audit difference. But since at the same time this new requirement in -- I can't remember what new requirement it was, but the new requirement around the discussion of audit differences, we were just trying to be clear about what constituted an audit difference. I never intended to have one. But we wanted to not wait for that. We wanted to be clear up front, and so just in terms of how you would operate within this policy and then tie that back to the other separate discussions we were having with them around – that I described to you, which this actually confirms what I was telling you earlier, pretax amount by 1 percent on adjustment [sic] that causes the net interest margin to move by a basis point, where it causes the fee rate to change by a tenth of a basis point. That's the earlier discussion that I was trying to describe to you.

[59] OFHEO Interview, Mr. Jonathan Boyles, August 24, 2004, p. 78-79

Q: During 1998, what was the company's policy for recording catch-up?

A: I don't recall there was a stated policy, and that was the issue that was raised with KPMG, They wanted a policy, and they wanted us to consistently apply a policy. And that was the genesis of the policy that we developed.

[60] OFHEO Interview, Mr. Jonathan Boyles, August 24, 2004, p. 79

Q: Do you recall whether or not the catch-up was booked to zero on a routine basis during that time?

A: I don't recall that it was ever booked to zero.

a $100 million threshold going back to the mid-90's.[61] During 1999 and 2000, the informal policy of the Enterprise was to stay within a $100 million threshold.[62]

The memorandum dated March 2, 1999 recommended that the range, within which the Enterprise did not need to recognize income or expense, be +/- 1% of projected revenue.[63] The policy adopted in December 2000, was consistent with this recommendation; however, the policy further established separate thresholds for purchase premium and discount amortization, and guarantee fee amortization. The threshold for purchase premium and discount amortization was stated as +/- 1% of Portfolio Net interest income, while the threshold for guarantee fee amortization was stated as +/- 2% of related Gfee revenue. These thresholds were referred to as the target catch-up for both of these respective revenue items.[64] As embodied in the December 2000 policy Enterprise management considered any point within the respective target catch-up ranges as the "functional equivalent of zero."[65]

Superficially, these ranges within which estimated income or expense will not be recognized may seem immaterial. However, OFHEO has concluded that such target thresholds are inappropriate for many reasons:

- SEC Staff Accounting Bulletin (SAB) No. 99 takes a dim view of defining any threshold of immateriality (no matter how small), and then purposely accounting for those transactions in a manner that does not conform to GAAP.

- According to management, the threshold was established due to the uncertainty of forecasting interest rates and prepayments. However, the range that the Enterprise has employed is not expressed as a range around the amount of calculated catch-up, but rather a more or less fixed threshold that is determined by reference to revenue amounts (e.g. NII) that include significant activity unrelated to amortization.

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[61] The attachment to an email from Mr. Tim Howard to Ms. Janet Pennewell, November 25, 2000, Subject: Amortization, states that "the second precedent is somewhat weaker but is KPMG's own – they were comfortable with a $ 100 million PDA threshold in the mid-90s, when our book was half the size it is today." Pennewell 08182004

[62] OFHEO Interview, Leanne Spencer, SVP Controller, June 22, 2004, p. 61.

Q: You said before there was roughly a hundred million dollar threshold.

A: I said that previously in when we were talking about inherent limitations of the model, what the model could do and couldn't do, that our auditors understood those limitations, and that it was an unwritten policy that was not documented, but it was an established practice we had in operating on our auditors that a plus or minus 100 million represented the acknowledgement of the imprecision that exists in this estimation process in connection with our model.

[63] Memorandum from Ms. Leanne Spencer and Ms. Janet Pennewell to Mr. Tim Howard, Subject: Policy on Purchase Premium/Discount Management, March 2, 1999, FMSE-SP 000110-000111.

[64] Purchase Premium and Discount Amortization Policy, December 2000, FMSE 074523-074524.

[65] OFHEO Interview, Ms. Janet Pennewell, June 15, 2004, pp.48-49

Q: So getting back to the plus or minus 1 percent threshold, which I understand you also called a target range, but if you are within that target range, policy doesn't require you make an adjustment, and in fact you may leave the amounts as you have recorded them during and through the quarter, correct?

A: That's correct.

Q: And you've also said that it's the – that the nature of the range is that it's the functional equivalent of zero?

A: Right. That's a phrase that we used for it, because again, that's our view as the level of precision in our estimate.

- The Enterprise's justification for such thresholds contradicts the basis for their election to change the amortization periods used from periods based upon contractual terms to estimated periods, which incorporated forecasts of prepayments.

- The thresholds are based upon *annual* income statement amounts, but are then applied in determining whether adjustments should be made to the *quarterly* financial statements.

- The thresholds are so large relative to the amounts of deferred price adjustment amortization that the retrospective adjustments required by SFAS 91 are unlikely to occur. As such, the Enterprise has effectively ignored this requirement of the standard by spreading income and expense due to normal market fluctuations over future periods.

- The Enterprise has provided no analysis which could separate what they have described as "artificial volatility"[66] from the actual market volatility of a mortgage portfolio.

- The range of the threshold is significantly larger than the amount of actual quarterly amortization and, in most cases, is almost as large as the amount of annual amortization.

- The Enterprise applied a different threshold to net interest income (NII) and guarantee fees (Gfee) despite the fact that both NII and Gfee are exposed to interest rates and prepayments in a similar manner.

In their testimony, members of Fannie Mae management have contended that the target range thresholds were necessitated by the uncertainty and imprecision associated with estimating the amortization of deferred price adjustments pursuant to the calculation of constant effective yield that was required by SFAS 91.

This line of reasoning on the part of management can be rejected on several grounds:

a. There is no basis of support either from a statistical standpoint or within Generally Accepted Accounting Principles for applying a range of uncertainty in this manner. The catch-up position for each respective source of revenue represents the

[66] OFHEO Interview, Mr. Tim Howard, August 5, 2004, pp. 187-188 (referring to Exhibit 8, Note for Janet Pennewell from Tim Howard, October 27, 1999, FMSE 217558).
Q: [...] Then the next paragraph reads, "I then attempted to use our projected PDA sensitivities to ask 'where would we like our PDA to be' in order to minimize the amount and frequency of PDA adjustments we would have to make as interest rates moved (as we know they will)." The question that I have for you is – well, actually, I have several questions. The first question is: Would you understand that FAS 91 would actually attempt to capture the volatility that would arise in both retrospective and prospective changes to purchase premium/discount interest amortization that would result from changes in interest rate fluctuations and result in changes in prepayments?
A: Yes. And this is a shorthand that I think not really accurately worded formulation. The attempt was never to minimize economic sensitivity. This is always in the context of not having our assumptions drive artificial volatility, so that's what we were talking about.

difference between 1) an amortization amount that was recorded during the quarter based upon assumptions made at the *beginning* of that quarter, and 2) an amortization amount estimated at the *end* of the quarter that uses the latest available information on current interest rates and actual prepayments experienced.[67] Imprecision and uncertainty indeed exist when making estimates. **However, the Enterprise is using this uncertainty and imprecision to rationalize why it need not recognize changes to income that simply result from fluctuations in market rates that occur naturally over time.**

b. The Enterprise's treatment of estimation uncertainty was not consistently applied, even *within* the accounting framework for deferred price amortization itself. Determining a constant effective yield in accordance with SFAS 91 requires both a retrospective (historical) and prospective adjustment based on the revised estimated amortization period due to changing rates of prepayments. Fannie Mae's objection to uncertainty seemed confined only to the immediate financial statement impact of the estimate. In fact, estimation uncertainty did not prevent Fannie Mae from adjusting the prospective amortization period of both discounts/premiums and guarantee fees in accordance with its revised estimate of prepayment speeds.

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[67] OFHEO Interview, Ms. Janet Pennewell, June 15, 2004, pp. 46-48.

Q: And only if the difference is 1 percent plus or minus do you make an adjustment. Otherwise you use what you've booked previously?

A: That would be true, yes.

Q: Now, why is what you booked previously a better estimate than the sensitivity analysis that you would perform at quarter end?

A: Well, what we're really saying is that because we don't exactly know what prepayments are going to do in the future, that you cannot know what your--how much you should have booked in the past with precision, and that that range of plus or minus 1 percent is meant to recognize the fact that you don't know with precision what your prepayments are going to do, and so therefore, you don't know with precision exactly how much you should have booked inception to date. So to say that--within a range, to say that--because it's kind of all the same, that's as close as you can get. It's just to recognize the degree of imprecision in coming up with that estimate position, because it is an estimate until you know exactly what prepayments are going to be in the future.

Q: I agree that it's subject to uncertainty, but when you're within the 1 percent threshold or when the difference is in the 1 percent threshold, why would what you booked previously be a better estimate than your latest modeling?

A: It's not necessarily a better--as good of an estimate than to us it is within what we call—we actually the term functional equivalent of zero to say, yeah, that's what our estimate is. Our estimate is a number within this range. That's as close as we can estimate it. It's kind of like—I always kind of think of it as polling error, so if you see a poll that says, you know, John Kerry's behind by 9 points, however our polling error is plus or minus 4 percent, so it's really not as close as it sounds. You've got polling error here. There are just certain aspects that you don't know with precision, and therefore there is not a precise number. And you'd fool yourself if you treated it as if there was a precise point in time number. There isn't.

Q: So because there is uncertainty, you in effect default to what you had previously booked as long as you're within the threshold?

A: Because what we previously booked, in the example that you give, where what we previously booked is within our range of what we think is exactly what we should have booked, that's as close as we can calculate the number. And we're saying what we did book was the correct amount to have recorded.

Fannie Mae personnel fully understood the prospective nature of their policy in their own characterization of their method for managing the catch-up position. An undated and unsigned document[68] provided by the Enterprise discusses a suggested defense to possible challenge by KPMG of the Enterprise's proposed amortization policy. The document states:

> We have traditionally used a prospective approach because it reduces our income statement volatility; we don't want to be placed in a position where we are booking a positive number one quarter and negative the next.

A memorandum from Mr. Tom Lawler dated April 2000 further states:

> We currently employ what I would call a 'modified prospective method' in determining the premium or discount amortization to be booked to current income. By that I mean that we do not manage our 'catch-up' position to zero each quarter.....It is a 'modified prospective method', however, in that if our catch up moves beyond a certain threshold, we then periodically may take a one-time adjustment into income to lower the catch up amount to a 'manageable' number.[69]

A prospective approach to adjusting income recognition on the amortization of deferred price adjustments is an explicit contravention of the requirements of SFAS No. 91. This accounting standard requires that the determination of constant effective yield be adjusted for the historical 'inception to date what-if' (retrospective) impact of changes in prepayment speeds each reporting period.

c. The Enterprise's rationale for the catch-up threshold because of uncertainty[70] in estimation calls into question their ability to elect to estimate prepayments (pursuant to the requirements of SFAS 91.) As mentioned previously in this report, FAS 91 requires that the amortization of deferred price adjustments be made over the contract life[71] (e.g., 30 years for a 30 year MBS.) However, such accounting could cause significant volatility in certain market environments. For instance, a large drop in interest rates could lead to a wave of prepayments.

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[68] Undated and unsigned document, Titled Proposed Amortization Policy, FMSE 217504 –217505.

[69] Undated and unsigned document, Titled Suggested Amortization Strategy, FMSE 217556-217557. This document has a handwritten note that indicates "from Tom April 00". In his testimony Mr. Tim Howard provided information regarding the sender of the document;

Q: Okay, I'd like to introduce into the record Exhibit 11.

A: I can tell you just from the style that this would have been written to somebody from Tom Lawler. I don't know if you knew that. It does say "from Tom".

[70] The Enterprise's rationale of uncertainty includes not only the designation of the target catch-up range, but also the estimation methods to determine the catch-up. See Appendix I.

[71] Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the **payment terms required by the loan contract** [Emphasis added], and prepayments of principal shall not be anticipated to shorten the loan term. SFAS 91, p. 19.

Under such conditions, previously unamortized amounts would be immediately recorded into income.

For large pools of similar loans, SFAS 91 provides an elective to companies that are seeking to avoid such volatility by including a forecast of prepayments in the determination of an estimated amortization period. The particular wording of this elective is as follows:

> **If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated** [Emphasis added], the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method.[72]

As such, the Enterprise's justification of large target thresholds based on the uncertainty of estimating prepayments does not reconcile to the elective in SFAS 91 which requires that "prepayments can be reasonably estimated.[73]" **As such, OFHEO has concluded that the Enterprise's adoption of a policy which establishes a threshold for recording adjustments to deferred price amortization is a violation of GAAP.**

d. Fannie Mae's treatment of estimation uncertainty is not consistent with the Enterprise's own treatment of other critical accounting estimates.[74] In addition to the amortization of deferred price adjustments, the Enterprise's Form 10K, filed with the SEC, identifies three other critical accounting estimates:[75]

    i. Determining the adequacy of the allowance for loan losses and guarantee liability for MBS;
    ii. Estimating the time value of purchased options; and
    iii. Assessing other-than-temporary impairment.

The Form 10K states that *all* of the critical accounting estimates "require significant management judgment and assumptions about highly complex and uncertain matters."[76] Yet, none of these other accounting estimates are determined in accordance with methods analogous to the 'target catch-up range' that is applied to the amortization of deferred price adjustments. In their testimony to OFHEO,

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[72] *Id.*
[73] *Id.*
[74] Fannie Mae Controller Ms. Leanne Spencer commenting on other critical accounting estimates. OFHEO Interview, Ms. Leanne Spencer, August 12, 2004, pp. 95-96.
Q: I just wanted to continue discussion around the purchase premium discount amortization policy. I think you have testified previously that you do not apply a target range to other accounting estimates of the company; is that correct?
A: I can't recall an area where we do.
[75] Fannie Mae 2003 Annual Report, pp. 39-40.
[76] *Id.*, p. 40.

officers of the Enterprise alternatively explained that the uncertainty associated with estimating deferred price amortization would give rise to "artificial"[77] or "spurious" volatility[78] of reported financial results. Many readers of this summarized report will understand that estimation uncertainty in statistical parlance refers to how *accurate* an estimate may be. But accuracy, in this context, is referring to an amount calculated at a point in time. Volatility, however, refers to the degree of change between an estimate made in one quarter, and the estimate made either the previous or following quarter. Therefore, uncertainty in accuracy and uncertainty in volatility are two different things. For example, a watch may be inaccurate because it is set 10 minutes ahead. However, that watch, all other things being equal, will still correctly mark the passage of three hours. While the Enterprise did prepare analysis that purported to demonstrate the extent of uncertainty associated with determining an estimate of deferred price amortization,[79] **OFHEO is not aware of any analysis ever prepared that demonstrates the existence, nature, or magnitude of any 'artificial' or 'spurious volatility' associated with estimating deferred price amortization.**[80]

Further undermining the argument of linkage between policy development and the manifestation of spurious volatility was the inability of Fannie Mae officers to explain why the target catch-up range for purchase premium/discount amortization (+/- 1%) was different from the target catch-up range for guarantee fee amortization (+/-2%).[81] Furthermore, the

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[77] OFHEO Interview, Ms. Janet Pennewell, June 15, 2004, p. 18.
Q: So isn't there actually some volatility in the business that you're in?
A: That's true. There certainly is volatility in the business that we're in, and certainly one would expect some volatility therefore in the premium and discount amortization that you're reporting. And what I was focused on was, what I really want to be very clear on is, artificial volatility. In other words, dramatic changes on what you're recording to income through FAS 91 because of what could be arbitrary changes in your assumption about interest rates. [...]

[78] OFHEO Interview, Mr. Tom Lawler, June 24, 2004, pp. 127-128.
A: [...] what we have first on the core data and modeling, we have some core uncertainties about the accuracy of the results, and sometimes there is the arbitrary nature of the date of the sensitivities we do, and we felt that in looking at the results swings that, in our mind, were spurious in nature or related to--unrelated to anything fundamental would be such that we would not want to, I believe the word they use here is book, although I don't do any booking.

[79] Memorandum from Mr. Jeff Juliane to Mr. Tim Howard, June 21, 2000, Subject: Amortization Policy Runs. FMSE 217521-217526.

[80] Fannie Mae officer Mr. Tom Lawler commenting on deferred price amortization. OFHEO Interview, Mr. Tom Lawler, June 24, 2004 p. 149.
Q: How did the company conclude that the inaccuracy in the modeling translated into spurious volatility?
A: How did we know for a fact that it created spurious volatility?
Q: Yes.
A: I don't know that I could demonstrate for a fact that it created spurious volatility. It was based on analysis sensitivities and time where we saw that, that the conclusion was that we felt it did, it could create spurious volatility.
Q: And did anyone at the time prepare an analysis or paper attempting to demonstrate that at the time?
FANNIE MAE COUNSEL: What time are we talking about?
Q: At the time you were formulating the policy at the 1 percent threshold.
A: I don't believe so.

[81] OFHEO Interview, Jonathan Boyles, August 24, 2004, pp. 34-35.

respective target catch-up ranges are each expressed in a curiously different manner. The +/- 1% portfolio NII target catch-up range for purchased premium and discounts is expressed as and determined on a *tax equivalent basis*, while the +/- 2% guarantee fee target catch-up range is expressed on a basis not adjusted for taxes. Indeed, the income tax treatment of these respective revenue amounts is in fact different. However, since both revenue amounts are reported in the financial statements before tax, modifying the threshold to reflect NII on a tax-equivalent basis would only be relevant to managing after tax net income or EPS. This convention would seem to have no relevance whatsoever to the issues of either estimation uncertainty or volatility of pre-tax reported financial results.

Could the motivation for focusing on estimation uncertainty have been a means to justify the application of a materiality threshold? In their response to requests for information made by OFHEO, the Enterprise responded that the basis for justifying the magnitude of the target catch-up range was an analysis prepared on June 21, 2000.[82] However, a memorandum[83] dated March 2, 1999 proposed a plus or minus 1% target catch-up well before the analysis dated June 21, 2000 was prepared.

A memorandum[84] dated April 2000 that Mr. Tim Howard testified was from Mr. Tom Lawler, explicitly refers to measures of materiality as the basis for determining the magnitude of target catch-up thresholds. A memorandum[85] dated September 23, 1999, from Ms. Janet Pennewell, Vice President Financial Reporting,[86] to Mr. Tim Howard devotes a section consisting of two paragraphs that discuss materiality. The first paragraph argues that it "may be appropriate to adjust the catch-up over time if the amount is not material,"[87] and even suggests that "since catch-up relates to the entire period since the mortgages/fees were put on the books, one could

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Q: Do you have an understanding as to why the target catch-up for purchase discount and premium amortization is plus or minus one percent and why alternatively for guaranty fee income, it's plus or minus two percent?
A: I don't recall why there is a difference.
Q: Do you recall seeing any analysis that would have demonstrated that the estimation of guaranty fee income is subject to greater uncertainty than purchase premium discount amortization?
A: I don't recall an analysis.
[82] Memorandum from Mr. Jeff Juliane to Mr. Tim Howard, June 21, 2000, Subject: Amortization Policy Runs. FMSE 217521-217526.
[83] Memorandum from Ms. Leanne Spencer and Ms. Janet Pennewell to Mr. Tim Howard, Subject: Policy on Purchase Premium/Discount Management, March 2, 1999, FMSE-SP 000110-000111
[84] Unsigned document, Titled: Suggested Amortization Strategy, FMSE 217556-217557. This document has a handwritten note that indicates "from Tom April 00."
[85] Memorandum from Ms. Janet Pennewell to Mr. Tim Howard, dated September 23, 1999, Subject: Policy on Purchase Premium/Discount Management, FMSE-SP 000106-000109.
[86] Ms. Janet Pennewell was Vice President of Financial reporting at the time this memorandum was written. In May of 2003, Ms. Pennewell was promoted to Senior Vice President Financial Reporting and Planning. OFHEO Interview with Ms. Janet Pennewell, June 15, 2004. p. 8
Q: So in 1999 you took on the responsibilities in Financial Reporting that you – describe what happened in 1999 again, if you would.
A: Sure. In 1999 I was promoted to Vice President, and before my promotion I was in charge of the business planning function, which resides within the Controller's Department, and when I was promoted to Vice President in 1999, also took on responsibility for financial reporting and for financial accounting.
[87] Memorandum from Ms. Janet Pennewell to Mr. Tim Howard, dated September 23, 1999, Subject: Policy on Purchase Premium/Discount Management, FMSE-SP 000106-000109.

argue that materiality should be judged in the context of multiple years of revenue."[88] The second paragraph however warns of SAB No. 99, which was released by the Securities and Exchange Commission just one month prior on August 13, 1999.[89] Clearly, management was thinking in the context of materiality – as opposed to uncertainty – at the time that memorandum was written. Lastly, as late as last year Fannie Mae's Office of Auditing describes the catch-up threshold as "a materiality threshold that is used in determining when differences should be booked."[90]

The Functional Equivalent of 16%

At this point, one might be forgiven for concluding that the thresholds ultimately adopted by the Enterprise were small in relation to the magnitude of the financial statement revenue amounts being reported. After all, management expressed the belief that the target catch-up was the functional equivalent of zero.[91] However, the thresholds either proposed or adopted were in reference to *annual* revenue amounts.[92] The effect on quarterly income was therefore much larger.

First of all, each of the percentage thresholds needs to be appropriately scaled to understand the impact on quarterly reporting. If we assume, for purposes of simplification, that quarterly revenue is approximately 1/4th of annual revenue, the percentage thresholds scale up to a quarterly effect of +/-4% and +/- 8% respectively. These percentages are the relevant threshold to understand the potential balance sheet effect on purchased premium/discounts and guarantee fees. To understand the potential impact on the volatility of reported earnings, the percentage thresholds need to be scaled further, in accordance with the full *range* of the threshold, to properly consider the impact on quarterly income. Since volatility refers to the degree of change between financial measures, in theory, quarterly guarantee fee catch-up could swing from +8% one quarter to -8% the next without any adjustment to income for the

[88] *Id.*

[89] *Id.*, FMSE-SP 000108. The full paragraph referred to reads:

"However, on August 13, of this year [1999] the Securities and Exchange Commission released Staff Accounting Bulletin (SAB) No. 99, which specifically addresses the application of "materiality" thresholds to the preparation and audit of financial statements. This bulletin was released in response to the SEC's concern about the tendency of companies, with the acquiescence of their auditors, to manage earnings by designating certain transactions or events below a certain percentage threshold as "immaterial" and the accounting for transactions and events in a manner that does not conform to GAAP. The bulletin states that the use of a percentage ceiling test alone to make materiality determinations is not acceptable. Although a quantitative test can be used as an initial assessment, all "facts and circumstances" must be evaluated to determine materiality - including whether a reasonable investor would find the amount to be material to the company's ability to meet earnings expectations."

[90] Fannie Mae Office of Auditing Workpaper, July 7, 2003, Reviewed by Ms. Joyce Philip, Manager Office of Auditing, FMSE 118802-118803.

[91] OFHEO Interview, Mr. Tim Howard, August 5, 2004, p. 124.

Q: And as long as it did not exceed the plus or minus 1 percent, then, in fact, no adjustment be required, correct?

A: Yes, because we deemed any estimate within the plus or minus 1 percent to be what we called the functional equivalent of zero.

[92] OFHEO Interview, Mr. Jeff Juliane, June 8, 2004, p. 199.

Q: On a quarterly basis, the cumulative catch-up amount is always evaluated in relation to one percent of projected annual net interest income?

A: Correct.

retrospective impact of that swing. **Therefore, the potential magnitude of avoided volatility becomes 8% and 16% of the respective quarterly revenue amounts.**

In 2003, the threshold for NII catch up was approximately +/-$110 million.[93] The associated range of this threshold therefore was over $220 million. It was this threshold and range that were applied to *quarterly* financial reporting. The highest amount of quarterly Net interest income related to purchase premium and discount amortization, for the period in which OFHEO has such information (Q1 2001 through Q1 2004), was approximately $151 million. The largest magnitude of change in purchase premium and discount amortization between consecutive quarterly reporting periods was approximately $135.8 million. The analogous threshold and range for Guarantee Fees was approximately +/- $45 million and $90 million, respectively.

In either case, when policy did not require that deferred price amortization adjustments be made the effect was to shift the catch-up amount to future periods, and the default amortization estimate in the current quarter would have been the estimate made at the beginning of the quarter. In quarters when the percent thresholds were exceeded and policy required that adjustments for estimated income or expense be made, the policy would have only required that amortization be adjusted to the amount of the target catch-up threshold. For example, if the target catch-up threshold was +/-$110 million, and the modeled catch-up estimate was $125 million, only a $15 million adjustment needed to be made under the policy.

The key attributes of the policy were that: 1) quarterly thresholds were pegged to annual amounts, 2) the additional scaling of a plus and minus range insofar as quarterly changes were concerned, and 3) the operation of policy whereby the Enterprise only recognized estimated adjustments that exceeded the range, allowed volatility to be avoided altogether - or at least significantly dampened – and future earnings surprises were rare.

The application of the quarterly thresholds results in the failure to record amortization and misstates financial results. Such misstatements mask changes in earnings and other trends that are important to investors. The SEC issued Staff Accounting Bulleting No. 99 to specifically prohibit such misstatements.[94]

Policy To Permit Discretionary Adjustments Within The Target Catch-Up Range

Yet another significant aspect of the Enterprise's policy was the ability of management to make discretionary adjustments[95] to quarterly income as long as they were within the target catch-up

[93] OFHEO Interview, Mr. Tim Howard, August 5, 2004, p. 147.

Q: And, in fact, I think, just to be more precise because I was using an approximation that the company has defined this 1-percent range as being as high as $ 110 million is my understanding.

A: As of the date of that document, that was probably true, but net interest income has been elevated for the last couple of years. So I think that's an outdated number.

Q: And possibly understated; is that –

A: Yes, it could be.

[94] SEC Staff Accounting Bulletin: No. 99 – Materiality, issued August 12, 1999.

[95] OFHEO Interview, Ms. Janet Pennewell, June 15, 2004, pp. 34-35

Q: Sometimes when you're under the 1 percent threshold, you may or may not make an adjustment?

A: That's correct.

Q: And that's based on management discretion?

range. While this was not explicitly stated in the policy, it arose as an extension of management's assertion that the 'functional equivalent of zero' was anywhere within the range. Accordingly, in 2003, when the NII target catch-up position approximated +/- $110 million, management had the ability to make discretionary adjustments to income of up to $220 million that, in theory, could move the catch-up from one end of the range to the other and still be permissible under their policy.

The following is a quote from testimony by Mr. Howard, CFO, regarding the latitude of recording adjustments to the catch-up position allowed in the amortization policy:

> Q: And then just to be clear, your terminology "deeper into the range" means that you could have booked an entry that would have made a positive catch-up a greater positive number, correct, in any given quarter?
> A: Right. If the calculated number was 120, and the minimum amount of the upper end of the range was 80, according to our policy, we needed to book the $40-million difference, but we were permitted to book--am I missing here?
> Q: No, keep going. I'm listening.
> A: We do the five scenarios, and each scenario we have an amount of catch-up that has to be recorded as income or expense to produce the level of yield [sic]. In averaging the five scenarios, we get a single number. And let me just assert that that number is $120 million, and the question is how much of that $120 million should be brought into income in the current quarter? Using our range--and let's call it plus or minus 1 percent--I will assert that 1 percent of net interest income, at this hypothetical time we're doing this, is $80 million. So that would mean that the smallest amount we could book as income was the difference between a $120- catch-up and the $80 million, top of the range. We could, by following the policy, conceivably book as much as $200 million of income, which would take us from the $120- all the way down to the negative $80-.[96]

Additionally, when asked about the ability to adjust earnings Mr. Tim Howard, Chief Financial Officer, provided the following testimony:

> Q: Okay. Now, were adjustments within the plus or minus 1-percent range ever made to cause actual earnings to more closely align with forecasted earnings, as far as you know?
> A: Not to my recollection.
> Q: Do you believe that would be prohibited under your policy?
> A: Technically, no.[97]

A: That's based on management's judgment in looking at our asymmetrical exposure to interest rates, yes.
Q: Is it ever based on anything else?
A: There might be other factors that management might look at in making that judgment, such as the current composition of the book. Most of those other things we might look at come down to evaluating, again, that asymmetry of the impact if rates don't move in line with how we forecasted them.

[96] OFHEO Interview, Mr. Tim Howard, August 5, 2004, pp. 139-141

[97] OFHEO Interview, Mr. Tim Howard, August 5, 2004, p. 207

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Subsequent sections of this report will provide examples in which the Enterprise exercised latitude in making adjustments within the range of uncertainty permitted by the policy. If accounting standards permitted this practice (which they do not), similar latitude could be applied to other estimates such as loan loss allowances, pension obligations and estimates of fair value. **If other companies used Fannie Mae's logic in applying accounting principles, they could dictate the financial results they desired, and there would be no comparability of financial results between reporting entities even within the same industry.**

Managing the Catch-Up

Managing Within The Current Quarter's Catch-Up Range

Another proposed mechanism to reduce earnings volatility was the intention to manage to a specific target level of catch-up. Targeting a specific level of catch-up was a means to minimize the probability that adjustments would be necessitated by exceeding either end of the plus or minus catch-up range. The idea essentially was to target a level of catch-up, such that the probability – in future periods - of exceeding one end of the range be no greater than the probability of exceeding the other end of the range. In this manner, the Enterprise could navigate the catch-up within the threshold range such that future income volatility which might arise through recording adjustments which would exceed the target threshold would be avoided. This objective, as well as the means, was suggested by the Chief Financial Officer himself to Ms. Janet Pennewell.

> Here's what I did in coming up with my proposed purchase premium and discount rule.
>
> First, I looked at our projections three years from now, and calculated the 'expected' amount of unamortized PDA.[98] This is simply the average of the results from the 'rates unchanged' and 'up and down 1 and 2 standard deviations' cases. Using the October projections, this 'expected PDA amount' in December '02 was $160 million.
>
> **I then attempted to use our projected PDA sensitivities to ask "where would we like our PDA to be" in order to minimize the amount and frequency of PDA adjustments we would have to make as interest rates moved (as we know they will).** [Emphasis added] To answer that, I looked at the sensitivity of our PDA calculations to up and down 2 standard deviation moves in interest rates in each of the next four years. What I found when I did that is that, on average over this period, if interest rates went up by two standard deviations, our so-called 'catchup' credit would increase by a positive $80 million dollars (roughly). For a two standard deviation fall in interest rates, however, the catchup would drop by $250 million – actually turning into a negative. So to make our corporate sensitivity to these rate changes symmetric, I figured that as long as our PDA sensitivity looked like this we should aim for a PDA catchup position of a positive $85 million. (That way, if rates moved up by 2

[98] PDA is the acronym for 'premium/discount amortization'

> standard deviations the catchup would rise by $80 million to a positive $165 million; if rates fell by 2 standard deviations our catchup would decline by $250 million, to a negative $165 million. That's symmetric.)
>
> My final step was to integrate the first and second paragraphs. That is, to say "given our current projected PDA sensitivity we want to be at $85 million; our probability-weighted expectation is that we will be at $160 million over the next three years, so to get where we want to be we should amortize the difference ($75 million) evenly into income over the next three years (at $25 million per year).
>
> I then added a couple of refinements to that. First, if the difference between where we were and where wanted to be was large (and particularly if it were large and negative), we would want to get back to our target more quickly than would be achieved by an even amortization over three years. So I would front-load the change – perhaps fifty percent in the first year, and 25 percent in the next two years.
>
> It also seemed to me that if we followed this procedure rigorously – i.e., we updated our PDA position and sensitivities, and our 'where do we want to be calculation' quarterly – we would find that the changes we would be making to our projected 'on top PDA adjustments' would be relatively small, spread out over a three year period. That would help with our goal of minimizing unnecessary net income volatility, while ensuring that we maintain an adequate amount of PDA amortization at all times. [99]

In a later memorandum[100] to Ms. Pennewell, dated November 25, 2000, Mr. Howard - on the eve of the adoption of the policy - further wrote:

> In looking out three years, we should look not only at the base scenario (rates unchanged) and the weighted average of the five scenarios, but also at the two extremes. The reason is to see whether we get a sense of whether we may find ourselves needing to move our catch-up quickly and in large amounts if rates move in a particular direction. This should affect where within the plus or minus $75 million range we aim for (i.e., if three years out the catch-up really plummets in the 'down 120' scenario, we should probably want to aim to be fairly high in the plus-or-minus $75 million range, as a cushion in case rates fall further).

This memorandum clearly shows that the intention of the policy the Enterprise adopted was to allow for positive (income) adjustments to the catch-up and to mitigate negative (loss) adjustments. OFHEO has concluded that such a practice is the equivalent to establishing a

[99] Memorandum from Mr. Tim Howard to Ms. Janet Pennewell, October 27, 1999, FMSE 217558

[100] Memorandum titled "Notes on Purchase Premium and Discount Amortization," attached to email from Mr. Timothy Howard to Ms. Janet Pennewell, November 25, 2000, Subject: Amortization. Howard 08152004.

reserve for amortization expenses. **However, since the catch-up was never fully recorded, the policy of the Enterprise effectively created a "cookie jar" reserve.**

In his testimony regarding the October 27, 1999 memorandum, Mr. Howard went on to state that the concept of a "where we want to be" target "never went anywhere."[101] However, a memorandum dated April 12, 2001, describing the Q1 2001 Amortization results, indicates that the Enterprise determined to make additional on-top adjustments for NII and Gfee of $10 million and $8 million respectively, of which each had the effect of increasing the catch up, even though the modeled deferred price adjustment amortization was within the respective threshold. In her testimony regarding the information contained within the April 12, 2001 memorandum, Ms. Leanne Spencer confirmed that it was management's practice to make adjustments because of the Enterprise's asymmetric exposure.[102] Ms. Pennewell, when asked about the practice of making adjustments within the catch-up range, also confirmed that the asymmetric exposure of interest rates influenced where management wanted to be within that range, and further pointed out specifically where within the *current* policy this practice would be supported.[103]

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[101] Mr. Tim Howard commenting on the memorandum to Ms. Pennewell dated October 27, 1999, FMSE 217558. OFHEO Interview, Mr. Timothy Howard, August 5, 2004, pp 197-198
Q: Would you regard the quarterly analysis that's done of catch-up as a "where we want to be calculation"?
A: No. The reason that's in quotes, this is – the "where you want to be" is looking out towards the famous moving target. This is not a "fiddle the number" concept. And that's why I put it in quotes. But, again, because this was sufficiently complex and hard to pin down, it never – the concept never went anywhere.
[102] Ms. Leanne Spencer commenting on a memorandum from Mr. Jeff Juliane and Mr. Rene LeRouzes to Distribution, dated April 12, 2001, Subject: Q1 2001 amortization update. FMSE-SP 000220-000223. OFHEO Interview, Ms. Leanne Spencer, June 22, 2004, p. 99.
Q: Would it have been your practice to sometimes book such an amount in because of this asymmetric exposure?
A: Yes.
Q: So, while you do not recollect specifically whether it was 10 million was booked or not, it could have been the case consistent with your practice.
A: Yes.
Ms. Leanne Spencer further commented. OFHEO Interview, Ms. Leanne Spencer, June 22, 2004, p. 100
Q: [...] and I assume you don't have any specific recollection specifically whether 8 million was booked or not.
A: I do not.
Q: But by analogy looking [sic] such an amount would have been consistent with practice that you might have employed?
A: Yes.
[103] OFHEO Interview, Ms. Janet Pennewell, June 15, 2004, pp. 33-34.
Q: Now, if this threshold were to be exceeded and you were required under your policy to make an adjustment to the quarter's interest amortization, you would only book the difference between the mean catch-up number and the threshold?
A: No. Our policy explicitly says that as long as we fall within that range, and the policy recognizes that we may use management judgment to recognize the fact that we typically have asymmetric exposure to interest rates. And so it's recognized that management may- that that may influence management's judgment in terms of where within that plus or minus 1 percent range we think is appropriate to be. Mortgages have a good deal of negative convexity, as I know you know, and therefore, depending on exactly the composition of our book, we won't – our catch-up position won't move symmetrically to, say, a plus or minus 100 basis point move in rates, and so where exactly within that policy range we thought it was appropriate to be, would typically be influenced by that asymmetry.

This practice and the latitude within the policy that authorized it, meant that the Enterprise was no longer making adjustments to improve the accuracy of its reported financial results. **Rather, the Enterprise was making preemptive adjustments for the sole purpose of managing prospective earnings.** OFHEO is not aware of any basis in promulgated accounting standards that would support this accounting treatment.

In his memorandum to Ms. Pennewell, Mr. Howard summed up the achievement of constructing the catch-up framework implemented by the Enterprise:

> There are variations on this theme, but you can see what I am trying to do. We have a target range that we define as the 'functional equivalent of zero'. We look at a three year horizon and multiple rate scenarios to try to avoid volatility in the monthly amortization numbers. And we give ourselves a (small) 'safe zone' before we force ourselves to make large changes in amortization to get quickly back to within our target range.[104]

Modeling And Managing The Forecasted Catch-Up

The discussion of catch-up thus far has focused on the impact associated with the reporting of *current* period income. However, a full understanding of the accounting for deferred price adjustment amortization, and its impact on the Enterprise's reported financial results, also has to consider the dimension of time and future reporting periods. For any given quarter, the quarterly catch-up amount is, by its very nature, simply unrecognized income or expense. The accounting policy adopted by the Enterprise specified the accounting to be applied to the catch-up in the current quarter. However, the policy also states:

> "In managing the premium/discount catch-up position, it is important to project how that position can change over time. We believe that a three year time horizon is appropriate for that assessment."[105]

Since catch-up is unrecognized income or expense, a *forecast* of catch-up is, in effect, nothing more than a forecast of *future* unrecognized income or expense. It was in this regard that the Enterprise devoted considerable systems and human resources to supporting a well developed and robust capability to forecast the level of catch-up in future periods, in accordance with the several years planning horizon referred to in the policy.

Each quarter, and often much more frequently, the Enterprise would perform analysis to determine both the current quarter's catch-up as well as the forecast of catch-up for prospective periods. The forecasting of prospective period catch-up would further be

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OFHEO Interview, Ms. Janet Pennewell, June 15, 2004, p. 83.
Q: Could you tell me in here where it refers to this policy around the negative convexity and booking within the target range that you referred to before?
A: It's on the second page, and specific – and I will tell you that the language that we look to in this policy is, "...we also need to be sensitive to the impact of extreme interest rate moves on our catch-up. This will affect where within our target range we should aim to be."

[104] Attachment to email from Mr. Tim Howard to Ms. Janet Pennewell, VP Financial Reporting & Planning, November 25, 2000, Subject: Amortization, Pennewell 08252004.

[105] Purchase Premium and Discount Amortization Policy, FMSE 074524.

performed pursuant to a variety of different assumptions, in order to determine, for example, the impact of different interest rate assumptions on future period catch-up.

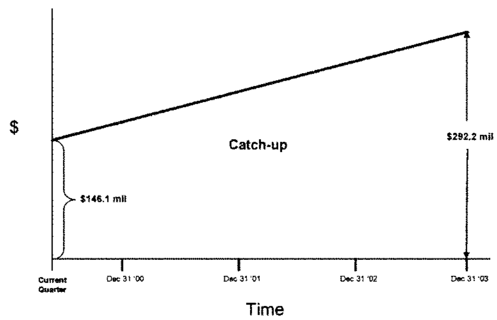
During the period from 1999 through to 2004, the Enterprise performed many sensitivity analyses for forecasting purposes. Over this timeframe, the relationship between forecasted catch-up for near term periods, and forecasted catch-up for outer periods varied. In 2000, the forecasts performed show progressively higher levels of catch-up, where the cumulative amount, at the end of the planning horizon, is significantly higher than the current period catch-up. For example, the table below presents a sensitivity analysis for the first quarter of 2000 that provides an estimate of the catch-up for prospective periods through to 2004 - the end of the planning horizon. This forecast was contained within a memorandum dated April 5, 2000. The forecasted catch-up for each period represents a weighted average of the catch-up calculated using prepayment estimates associated with each of five interest rate scenarios: Base Rate Path, +/- 60 basis points and +/- 120 basis points.[106] See Appendix I of this document for a more detailed description of the modeling methodology.

Forecast Period	5-Apr-00 Analysis
Dec-00	$183.0
Dec-01	$222.0
Dec-02	$258.0
Dec-03	$292.2
Base rate path used	8.65%
Book used	Jan-00
Reference	*FMSE-SP 000237*

Another way to understand the catch-up is to view it graphically. The following is an illustration that uses the estimate of catch-up contained within the April 5th 2000 analysis.

[106] Memorandum from Mr. Jeff Juliane to Ms. Leanne Spencer, dated April 5, 2000, Subject: Amortization Sensitivities. FMSE-SP 000236–000238.

Illustration

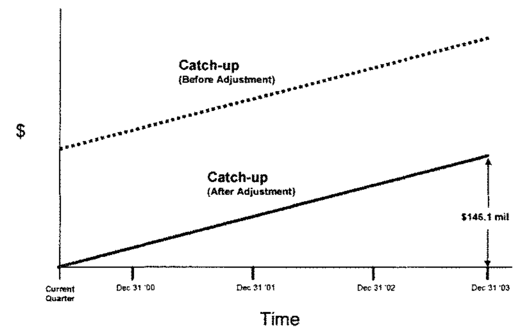


The catch-up represents the difference between the projection of deferred price adjustment amortization in accordance with a forecast using multiple up and down rate path scenarios versus the prospective amortization that would be taken in accordance with 'in-use' amortization factors applied prospectively. The level as well as shape of both the catch-up, and prospective amortization could however vary. This is due to the fact that such amortization could include the amortization of both premiums and discounts. All other things being equal, the amortization of premiums would result in projected expense and the amortization of discount would result in projected income. The projected amount of net interest income from the amortization of both premiums and discounts would be a combination of the two. This net amount, therefore, is going to be impacted by whether there are more premiums or discounts associated with the underlying mortgage assets held by the Enterprise. Further complicating this is that at any given point in time, the mortgage assets held by the Enterprise have varying estimated lives. For example, a 15 year mortgage has a different estimated life than a conventional 30 year mortgage.

For purposes of this discussion, the shape and level of expected amortization is not important. The illustration is meant to show the nature of the catch-up itself. In this example, the sensitivity analysis prepared on April 5, 2000, serves as an example of the catch-up calculation that would be made in the current quarter. The estimate of current quarterly catch-up would then be subject to comparison to the catch-up target threshold in effect in order to determine if an adjustment to the *current* quarter's income is required. Alternatively, the estimate of the subsequent year's catch-up is, in this illustration, an estimate of the cumulative amount of future unrecorded income (catch-up) that would exist at each point forward if no other action is taken.

Hypothetically, if the Enterprise were to record the entire amount of the current quarter's catch-up, the forecasted catch-up for subsequent periods would be similarly affected as well.

Illustration



OFHEO believes that the methods selected and infrastructure developed to support the estimation of prospective unrecognized income or expense, were in fact designed to facilitate a proactive management of earnings that extended well beyond the flexibility merely afforded by the Enterprise's accounting for the *current* quarter's catch-up. This contention is supported both by a conceptual understanding of the catch-up and estimation methods used, as well as by the actual practices and accounting employed by the Enterprise that are documented both within this section, as well as other sections in this report.

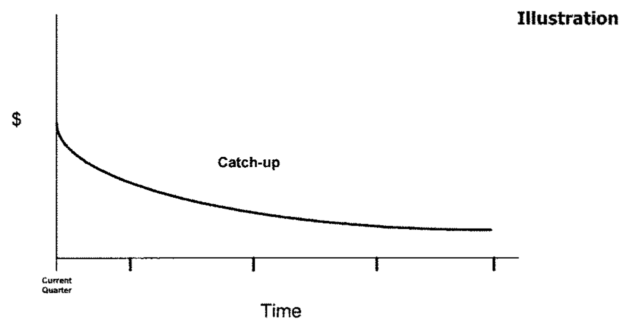
<u>Relationship of Catch-up to Amortization</u>
Outer periods that have a greater magnitude of either unrecognized income or unrecognized expense than the current or nearer term periods do, suggest a divergence between two estimates that conceptually should either be the same or at least be converging.

SFAS 91 requires that a retrospective - "inception to date what-if" - adjustment be made to accumulated amortization and the corresponding income statement (amortization) account. This adjustment would be based on the latest estimate of the effective life of the mortgage assets being amortized. SFAS 91 also requires that the mortgage assets be amortized *prospectively* over the new estimate of effective life. Presumptively, the estimated life of the deferred price adjustments would be the same for both the retrospective and prospective treatment. Why then, would forecasted unrecognized income or expense be growing in magnitude?

In making the adjustment required by SFAS 91, there should be no unrecorded income or expense other than the momentary difference that should then be immediately recorded, from applying the revised forecast of the new estimated lives of the mortgage assets that forms the basis of the retrospective adjustment.

If hypothetically, a reporting entity were permitted to avoid making the retrospective adjustment under SFAS 91, the forecasted amount of unrecorded income or expense associated with that treatment would then be either positive or negative but should still nevertheless, be

diminishing and converging to zero. The following graphic illustrates this effect in a circumstance where a positive (income) retrospective adjustment is not made.



In the circumstance above, one would expect that the difference, between the amortization that *should* have been recorded and the amortization that *was* recorded, should diminish. The rate at which the unrecorded amortization would diminish would be a function of the rate at which the portfolio of mortgage assets itself is diminishing due to mortgage loan prepayments. In a typical pool of mortgages, the rate at which mortgages prepay – and the portfolio diminishes – is faster earlier in the life of the pool, than at the end.

This expectation of diminishing differences however, was not always reflected in the forecasts of catch-up at the Enterprise. The graph below shows the forecast of guarantee fee[107] catch-up for the first quarter of 2004.[108]

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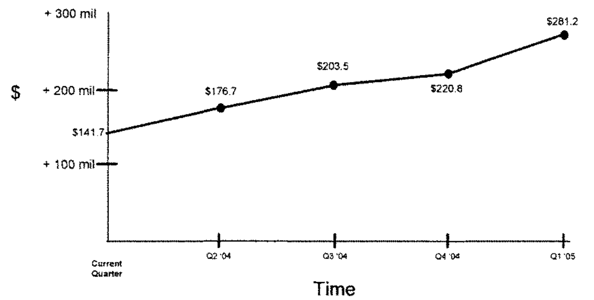
[107] Fannie Mae started to separately track the catch-up associated with purchased premiums and discounts and guarantee fee separately, in accordance with the requirements of the December 2000 purchased premium and discount amortization policy. Purchase Premium and Discount Amortization Policy, FMSE 074523-074524.

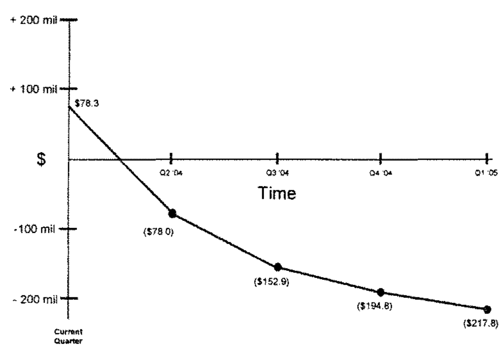
[108] The first quarter 2004 estimate of current quarter catch-up was further adjusted by the correction of an error related to the treatment of Dollar Rolls. The impact of this correction resulted in an adjustment to NII that reduced that catch-up by approximately $36 million. Accordingly, all prospective periods of forecasted catch-up would have been similarly affected as well. OFHEO utilized the 'before adjustment amounts' since it did not have the 'post adjustment' analysis.
Memorandum from Jeff Juliane and Rene LeRouzes, Subject: Q1 2004 Amortization Results, to File, dated April 27, 2004, FMSE-SP 000260-000265 and
Memorandum from Mukul Gupta, Subject: Error in Amortization of Securities Used in Dollar Rolls, to Distribution, dated May 3, 2004, FMSE-SP 000266-000272. Distribution included among others Ms. Leanne Spencer, Mr. Jonathan Boyles, Ms. Janet Pennewell.

GFEE



This analysis shows the estimate of catch-up to be growing over subsequent prospective quarters. The next graph shows the forecast of NII catch-up for the same period:

NII



In either case, the magnitude of forecasted unrecognized income and loss should be trending towards zero in subsequent periods.

The selection of the catch-up forecast for the first quarter of 2004 was specifically made because according to the testimony of Fannie Mae management decided not to make any 'in use' factor changes at the end of that quarter. OFHEO does not find this decision to be appropriate. However, it serves a useful purpose since the Enterprise could not provide many

instances where full catch-up forecasts were performed on both a before and after 'in use' factor change basis.[109]

Appendix I provides an analysis of the estimation methods that Fannie Mae employed to determine the catch-up. As noted in this appendix, the Enterprise uses a *different* method for forecasting catch-up and estimating prepayment speeds for determining the SFAS 91 retrospective adjustment than it uses for determining prospective amortization. Pursuant to the analysis provided in the appendix, OFHEO has concluded that Fannie Mae's forecast of catch-up and estimate of the SFAS 91 retrospective adjustment, based on their method of using multiple rate paths and related assumptions, is incorrect. In addition, since the Enterprise's own forecasts of catch-up do not consistently show a diminishing level of catch-up, **OFHEO has further concluded that the estimate of effective lives used for prospectively amortizing deferred price adjustments is also incorrect.**

The Use of Catch-up to Promote Earnings Stability and Shift Income or Expense between Periods

In two previous sections, this report described 1) the latitude of the Enterprise – within the framework of policy – to recognize discretionary income or expense within the target threshold range, and 2) the view that the catch-up was to be managed in accordance with maintaining a target level of catch-up, such that the potential of exceeding the target range thresholds and the resultant earnings volatility, was minimized.

The capability to forecast catch-up therefore was, among other things, the means to steer toward the desired target catch-up. Making discretionary adjustments within the target range served to propel the Enterprise toward this goal. A challenge however, would be the wake of earnings volatility that such navigation created. In this regard, course corrections using such discretionary adjustments would themselves potentially create an undesirable impact in the quarter in which they were made.

A memorandum[110] dated April 12, 2001 from Jeff Juliane and Rene LeRouzes indicates that planned on-tops of $75 million of income related to NII, and $57 million of expense relating to GFEE will be taken prospectively via 2001 amortization factors. The memorandum further states that 1) an additional $10 million of on-tops will be booked for 2001 "to hedge our exposure if rates continue to decline,"[111] and 2) "However, since we are disproportionately exposed to the Gfee catch-up in the down sensitivities (50 and 100 bps respectively), it was

[109] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, p. 15.
Q: Getting back to the instances you described before where the rate change was not processed, can you recall specifically what period that was?
A: The only period I can recall was Q1 – it was the April 2004 rate change. We did not process the April 2004 rate change.
Q: And that's the April 2001 –
A: Four.
Q: April 2004, okay.
[110] Memorandum from Mr. Jeff Juliane and Mr. Rene LeRouzes to Distribution dated April 12, 2001, Subject: Q1 2001 Amortization Update. Distribution included Mr. Tom Lawler, Mr. Peter Niculescu, Ms. Leanne Spencer and Ms. Janet Pennewell. FMSE-SP 002787–002790.
[111] *Id.*

decided to layer on an additional $8 million of expense on-tops in 2001. This results in a total on-top amount of $66 million of related expense for 2001."[112]

The practice of booking scheduled monthly on-tops was previous practice at Fannie Mae. OFHEO's examination procedures did not extend to an exhaustive review of accounting records to determine all instances in which this occurred. However, in 1999 and 2000 OFHEO is aware of scheduled on-tops taken to reduce the $200 million deferred expense not taken in 1998. In addition, for purposes unrelated to this $200 million, scheduled monthly on-tops were made in 2000 as well.[113]

The memorandum dated April 12th 2001 however, is OFHEO's first understanding that scheduled on-tops were now being made as factor change adjustments. Within the amortization system itself, adjustments to current quarter and future period income could now be made. There are further instances of on-top adjustments being made through factor changes.

More significantly, and as noted in subsequent sections of this report, there are numerous instances where the impact of other accounting events were capitalized as phantom assets or liabilities within the amortization system and subsequently amortized over a 30-year conventional mortgage proxy life. Typically, these items were reconciliation differences between various accounting sub-ledgers that had an income statement effect; however, other accounting events of a different nature were treated in similar fashion as well. Thus, earnings volatility could be managed and income shifted from one period to another.

In fact, just two quarters prior to the commencement of the scheduled factor amortization adjustments of 2001, an unsigned note to Ms. Janet Pennewell stated the following:

> Lost $20 million in catch-up due to rate change and picked up $30 million in catch-up due to change in book (recognizing to [sic] little discount into income). Lost $78 million in catch up due to methodology change (short term CPR's were changed from 3-months to 24-month) to slow down the recognition of discount into income in request to reducing the positive catch-up and transferring income into the outer years.[114]

The use of the amortization process to effect changes to the Enterprise's financial statements also supports OFHEO's contention that Fannie Mae management selected estimation methods that understated the true level of the catch-up. Any items, on-tops or other accounting events that had an income statement impact would have had the earlier noted effect of reducing the estimate of prospective catch-up for all forecast horizons impacted. In this regard, having a

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[112] *Id.*

[113] Memorandum from Mr. Rene LeRouzes to Distribution, dated October 17, 2000, Subject: PDA/REMIC Results (August Book), the distribution list includes Ms. Janet Pennewell and Mr. Jeff Juliane. FMSE-SP 000113-000116. This memorandum states: "With the Q3 update, our on-top adjustments for the remainder of 2000 and the forecast horizon was revised. Previously, we were booking approximately $8.0M monthly ($1.8 M Gfee, $6.0 M NII) for the balance of 2000. Revised for the Q3 update, and incorporated within the forecast, on-tops are approximately $2.0M monthly ($.7M GFee, $1.0M NII) for the remainder of the year."

[114] Undated document titled: "Notes for Janet – Explanation of results." FMSE-SP 002590.

large catch-up would be preferred. In theory, the catch-up could mechanically support the ratable recognition of stable earnings, or the shifting of income between periods, if it was in either a positive or negative position. However, it would be much better to have a proportionally larger, rather than smaller, unrecognized income to cushion against earnings volatility – both market driven (i.e., changing prepayment estimates) and event driven (reconciliation errors). A larger rather than smaller catch-up could also serve as a reserve that could be drawn from or replenished as necessity might dictate.

The use of the amortization system to effect adjustments to the financial statements also provided a means to contravene the internal controls that would otherwise be necessary when making adjustments to the general ledger. Accounting systems, as well as traditional related internal controls, serve to highlight such entries both on a current basis as well in accordance with maintaining a history or an audit trail of such adjustments that would facilitate inquiry and critical review. The amortization system on the other hand was not subject to these same internal controls. **A diminished transaction trail, key person dependencies, as well as accounting effects obscured within sub-ledgers containing hundreds of thousands of records, were all manifestations of the process of amortization at Fannie Mae.**

Subsequent sections of this report will detail matters concerning the weak control environment associated with the amortization process. We have concluded that Fannie Mae tolerated significant control weaknesses as a further means to obscure the management of the catch-up and any related income effects.

Development of Systems and Modeling Capability

OFHEO has concluded that iterative modeling of the catch-up was performed for both the current quarter as well as prospective reporting periods for the purpose of generating results under varying assumptions in order to achieve a specific desired outcome.

The active modeling and management of both current and forecasted catch-up required systems applications more robust than the Enterprise previously had. This section of the report links methods for modeling and managing the catch-up that were previously described, to systems functionality specifically designed to support them and the earnings management intended. Subsequent sections of this report, as well as the included appendix titled "Estimation Methods Used for Modeling the Catch-up" will document examples of instances where either iterative modeling was performed or assumptions were selected specifically to achieve desired financial results.

In 1998, the Enterprise anticipated this need and installed an application called "BancWare Convergence" (hereafter referred to as "BancWare"). This software was "purchased and installed as a tool to facilitate the scenario analysis of our purchase discount/premium and deferred/ prepaid fee position."[115] In a memorandum dated March 12, 1999, Mr. Jeff Juliane

[115] Memorandum from Mr. Jeff Juliane to Distribution, dated March 12, 1999, Subject: BancWare Convergence – Next Steps, distribution included; Mr. Tom Lawler, Ms. Leanne Spencer, Ms. Mary

described that the first phase of implementation began in the fall of 1998 and further advocated the elevated priority of functional development. In commenting on the capability now provided by BancWare, Mr. Juliane noted: "Phase I of the conversion to BancWare was completed recently increasing our 'what-if' capabilities in analyzing purchase premium/discount and deferred/prepaid fees on the core book of business."[116] Commenting on upgrades in capability achieved in Phase I, Mr. Juliane further noted that "These upgrades created enhanced cash flows, which improved our catch-up forecasting ability."[117]

In commenting on the need for a specific additional enhancement that would allow BancWare to produce modeling reports in dollars, and therefore bypass PDAMS[118], Mr. Juliane states a need for producing multiple scenarios quickly: "This enhancement would eliminate the need to run scenarios through PDAMS to produce useable reports. This greatly enhances our ability to produce multiple scenarios within short timeframes." [119]

Commenting on needs beyond speed, and providing a stated objective for certain desired capabilities, Mr. Juliane further wrote:

> BancWare amortizes premium and discount using an interest proxy method based on a proportionate amount of principal collected. This generates an amortization amount that ensures that the purchase price is maintained throughout the life of the instrument. Consequently, the normal amortization factors BancWare produces assume that you record catch-up in the period when incurred. **However, even though the normal factors assume that you will recognize catch-up in the period incurred, BancWare gives you the flexibility to manipulate the factors to produce an array of recognition streams.[120]** [Emphasis added]

Mr. Juliane continues in the paragraph:

> With this manipulation you can 'bleed' the catch-up within a specified time period and affect both the subsidiary ledger as well as the general ledger equally. This strengthens the earnings management that is necessary when dealing with a volatile book of business.[121]

Further in the memorandum, Mr. Juliane describes additional functionality that – if built - would provide further flexibility and control over the recognition of the catch-up:

Lewers, Mr. Jonathan Boyles, with copy to Ms. Janet Pennewell and Mr. Rene LeRouzes, FMSE-SP 000364–000367.
[116] *Id.*
[117] *Id.*
[118] Purchase Discount Amortization System. This was the system used at the time by the Enterprise to model catch-up.
[119] Memorandum from Mr. Jeff Juliane to Distribution, dated March 12, 1999, Subject: BancWare Convergence – Next Steps, distribution included; Mr. Tom Lawler, Ms. Leanne Spencer, Ms. Mary Lewers, Mr. Jonathan Boyles, with cc to Ms. Janet Pennewell and Mr. Rene LeRouzes, FMSE-SP 000364–000367.
[120] *Id.*
[121] *Id.*

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> It is recommended that we adopt the amortization method currently used within BancWare. It applies Fas [sic] 91 more consistently than our PDAMS process and has the ability to generate factors that give us multiple recognition patterns that create maximum earnings flexibility. We will need to build a table within BancWare (or multiple tables) that will allow us to control the period over which catch-up is recognized.[122]

OFHEO believes that the catch-up convention itself is inconsistent with the requirements of GAAP. **It is clear however, that in addition to not recognizing amounts that should be recorded in the current period as they are estimated, the Enterprise intended to also manage the prospective periods over which the deferred amounts were managed, and devoted resources in order to systematically apply this inappropriate treatment.**

Additional sections of this report will demonstrate the circumstances under which this capability was used.

Historical Analysis of Accounting for Deferred Price Amortization

The previous discussion of OFHEO's preliminary findings on accounting for deferred price amortization focused on the Enterprise's accounting at the end of 1998 and years immediately subsequent, as well as the formulation of a policy that led to the adoption of the Enterprise's policy in December 2000 that remains in effect currently. But what was the impact?

We have attempted to illustrate the effect that the Enterprise's policies and practices have had on the recorded amount of amortization. All of the information that these charts are based on was provided by the Enterprise. While we have made adjustments to reflect the impact of particular aspects of the Enterprise's policies and practices, in some cases this was difficult due to inconsistent information and inadequately described adjustments. It should be noted that while we have included adjustments to amortization for the periodic swings in the catch-up level, we have concluded elsewhere in this report that the calculation of the catch-up level was not consistent with the requirements of SFAS 91.

An overview of the effect is illustrated in the following charts which show how the implementation of the Enterprise's amortization policy reduced income statement volatility:

[122] *Id.*

Chart 1:

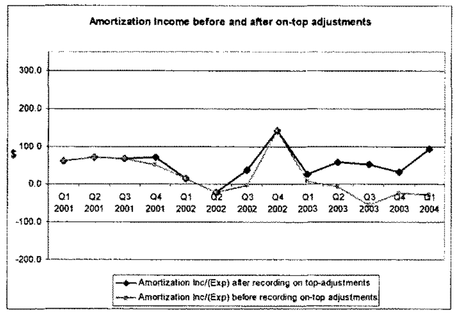

Chart 1 shows the effect the on-top adjustments had on the recorded amount of amortization income or expense.

Chart 2:

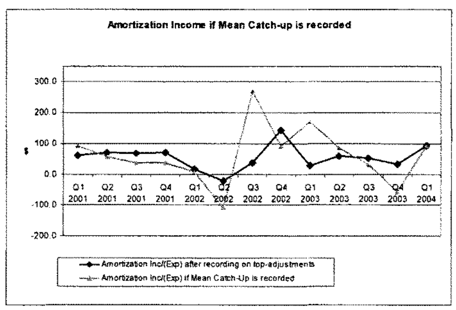

Chart 2 shows the effect of recording the mean amount of catch-up to $0 at each quarter-end. The base amount is calculated using a base rate path, which is the interest rate path the Enterprise deems to be the most likely forecasted rate. Such base rate path is then used to generate a forecast of prepayments. The mean amount is a simple average using the base rate path and 4 shocks scenarios of up and down 50 bps and up and down 100 bps. As we have noted elsewhere in this report, we do not believe that the mean catch-up would be equivalent to the retrospective adjustment that is required by SFAS 91. However, this chart does show that the Enterprise's policy of applying the catch-up thresholds and not recording the mean

amount to $0 at each quarter end had the effect of significantly reducing the volatility of recorded amounts.

Chart 3:

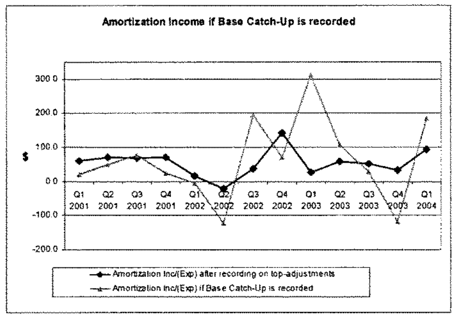

Chart 3 shows the effect of recording the base amount of catch-up to $0 at each quarter-end. This analysis clearly shows that, not only did the Enterprise's policy provide more stable earnings but also the use of the mean of the five scenarios in the calculation of catch-up further served to minimize the volatility of the catch-up position (as compared to the base amount of calculated catch-up) in certain periods.

Chart 4:

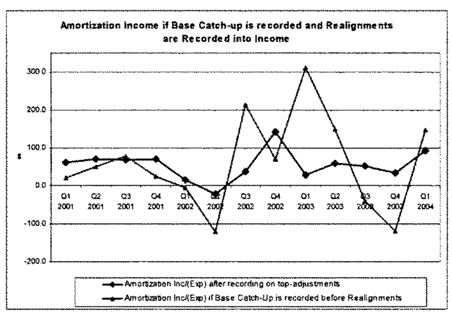

Chart 4 shows both the effect of recording the base amount of catch-up to $0 at each quarter-end as well as what the impact would have been if the reconciliation differences had been recorded (rather than capitalized and amortized over proxy lives) in the periods that they were

calculated. Although the true determination of what amounts should have been recorded in prior periods is a matter of ongoing examination, this chart adequately depicts the total impact of some of the Enterprise's policies and practices based upon the information we were provided.

The remainder of this section provides further specific examples regarding the Enterprise's *application* of its policies. These *examples* are intended to illustrate our findings. **OFHEO is still in the process of reviewing further information and analysis regarding the Enterprise's accounting for deferred price adjustment amortization.** Examples of the Enterprise's accounting for deferred price adjustments include:

a. On two occasions during 2003, a variety of means were employed to affect the amount of catch-up adjustment required during periods in which investment analysts' expectations would otherwise not have been met.

b. Numerous sensitivity runs of the catch-up were performed so that results under different assumptions could be evaluated. In the instances reviewed, assumptions were selected so that generated results would trigger adjustments to income in order to produce desired financial results.

c. Management exercised discretion in accordance with the adopted policy in the selection of interest rate assumptions to ensure desired financial results were achieved.

d. Inconsistent accounting practices were applied in the determination of the catch-up position. These inconsistently applied practices allowed management to avoid exceeding the thresholds for the catch-up position.

e. Reconciliation differences between information maintained on sub-ledgers and information used by the catch-up modeling application were recorded as 'phantom' assets or liabilities and were amortized over subsequent years.[123]

Management of Catch-Up Results

The Enterprise's policies for accounting for amortization were purposefully designed and implemented in a manner that provided management with the discretion to adjust the amount of recorded income or expense as long as such adjustments were made to reduce catch-up to the threshold amount as well as within the target catch-up ranges. This gave management the means to mitigate the volatility of income that is normally associated with a large mortgage portfolio, and further gave them the flexibility to achieve desired financial results.

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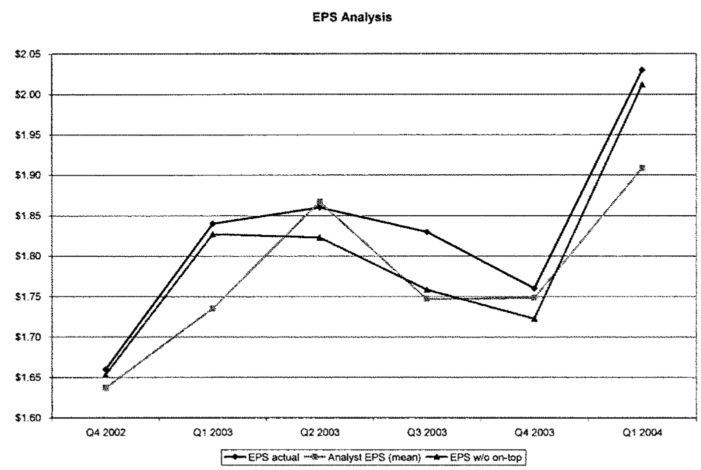
[123] Fannie Mae Audit Report, Office of Auditing, Amortization Audit, dated July 9, 2003, FMSE 023745-023752 under the caption 'Data Processes' states:
"Because of systems and process limitations, reconciliation differences exist between the amortization account sub-ledgers (STATS and LASER), the G/L, and the amortization database (PDI). For this reason, the various systems need to be periodically realigned, resulting in adjustments to original unamortized accounts and accumulated amortization account balances.
These adjustments ranged from $700 thousand to $45 million during the period 11/2002 to 5/2003. Management's practice has been to expense smaller differences, to book and amortize larger differences as new acquisitions, or incorporate the differences into the overall Catch-up balance."

In addition, the Enterprise engineered the catch-up results to generate a catch-up amount that exceeded the threshold, in order to trigger a specific amount of an on-top adjustment pursuant to the policy.



During Q2 and Q4 of 2003, on-top adjustments were recorded that - after adjusting for the effect of income taxes - allowed the Enterprise to meet (or very closely meet) analysts' estimates. Such adjustments made to the accounting for amortization - during the period since the Enterprise began filing public financial information - were contrary to SEC Staff Accounting Bulletin No. 99 (SAB 99).

In June of 2003, the consensus EPS estimate for Fannie Mae was $1.867 per share and the low estimate was $1.81 per share.[124] The actual EPS of Fannie Mae prior to recording the on-top adjustment would have been only $1.82 per share. After recording the on-top adjustment, the final EPS amount was $1.86 per share.

The amount of the on-tops recorded for the June 2003 closing were $21.2 million for NII and $24.9 million for Gfee. The amount of the on-top required (per the Enterprise's policy) as of June, 2003 was significantly affected by two different events. Both of the two events described below had the effect of increasing the amount of income to be recorded without borrowing too much income from future periods:

- First, the interest rate selected for the computation of the catch-up as of June 30 was specifically changed to incorporate interest rate drops that occurred (primarily during the

[124] Source: Bloomberg

month May).[125] OFHEO has concluded that the interest rate chosen by the Enterprise for the June 2003 catch-up sensitivity was chosen, in part, because of the effect that such a change would have on the amount of income for the quarter as well as the *forecasted* amount of catch-up. Essentially, the rate was chosen to increase income, but in a measured fashion. See Section "Management Discretion Applied in the Selection of Market Assumptions" for more information on this matter.

- Second, the Enterprise began to add certain capitalized reconciliation differences to the catch-up results (in addition to the impact of certain forecasted reconciliation differences which had been included in the catch-up analysis beginning in the prior quarter.) Again, the inclusion of a *forecasted* reconciliation difference in the catch-up results shows that management was thinking about current and future periods in determining the amounts to be recorded in the financial statements. OFHEO has concluded that the inclusion of such realignment differences in the catch-up sensitivity is not appropriate. See Section "Inconsistently Applied Accounting Practices to Determine the Catch-up" for more information on this matter.

In December of 2003, the consensus EPS estimate for Fannie Mae was $1.75 per share.[126] The actual EPS of Fannie Mae prior to recording the on-top adjustment would have been only $1.72 per share. After recording the on-top adjustment, the final EPS amount was $1.76 per share.

The December 2003 catch-up analysis was notable for the manner in which the catch-up amount was determined. In this circumstance, multiple catch-up sensitivities were run[127] before the final catch-up amount was determined. OFHEO has received draft sensitivity reports generated on January 5, January 6, and January 8, 2004. In addition, there was a final draft sensitivity report, which is undated, but which matches the amount of the final on-top adjustment which was recorded on January 10, 2004.

In addition, there were two journal entries used to record the on-top adjustments. The first journal entry, dated January 7, 2004 was for $50.1 million of income.[128] The entry is supported by a sensitivity analysis and bears a number of authorizing signatures including sign-offs by Mr. Juliane and Ms. Pennewell. The second entry, dated January 10, 2004 was for an additional $6.5 million.[129] Such activity, on its face, may not raise much attention. But in retrospect, it seems suspect. The final catch-up threshold for the fourth quarter of 2003 was $110.2 million. If a sensitivity analysis was run on January 7th and an on-top had already been recorded, then why would another sensitivity analysis need to be run? Also, why would the result, a mere $6.5 million then be recorded? The $6.5 million number seems especially small when you consider that, according to the definition provided by management, the "functional equivalent of zero"[130] was +/- $110.2 million?

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[125] The Fannie Mae 30-year coupon dropped from 4.908% on April 30, 2003 to 4.177% on June 12, 2003. The rate then rose to 4.648% on June 30, 2003. Source: Bloomberg. FMSE 194295-194296.
[126] Source: Bloomberg
[127] For bates ranges see references in the table on the following page.
[128] Journal Entry Dated 1/7/2004, FMSE 216777
[129] Journal Entry Dated 1/10/2004, FMSE 216778
[130] OFHEO Interview, Mr. Tim Howard, August 5, 2004, p. 151
Q: And do you think that, given the historical amount of the variability, that even an annual variability, that the $ 200- or potentially greater than $ 200-million target range that you apply is reasonable?

The results of the four sensitivities that we received are compared in the following table:

Date	NII Catch-Up Mean	Catch-Up Threshold	Difference	Comments
January 5, 2004	$ 173.5	$ 109.5	$ 64.0	Marked "Not Final"
January 6, 2004	159.6	109.5	50.1	Agrees to on-top recorded on 1/7
January 8, 2004	133.6	110.2	23.4	Marked "Alternative"
January 10, 2004	166.8	110.2	56.6	Agrees to combined on-tops recorded on 1/7, 1/10

Bates numbers (in order by date above): FMSE-SP 002872, 002875, 002869, and 002502

As the table above shows, the NII catch-up was recalculated twice after the on-top journal entry was recorded on January 7, 2004. In addition, it should be noted that the NII revenue target was also slightly adjusted from $109.5 million to $110.2 million. The adjustment of the NII target had the effect of changing the catch-up threshold itself.

As of the date of this report, we have received no specific evidence that such adjustments were made to intentionally match the analysts' estimates. However, the existence of multiple sensitivity runs, the timing of their production and the small amounts of on-top journal entries recorded suggests that results were generated to achieve desired financial results.

A reason for the multiple runs however, *is* suggested by Mr. Juliane's 2002 performance appraisal. That performance appraisal states:

Under a section entitled "Objective 1" of Mr. Juliane's 2002 year-end appraisal, the following statement appears (among others): "Assist management to reach results that fit within established guidelines." Under the "Results Achieved" section of Objective 1, the following appraisal if provided:

> This was an extremely intense year as record low interest rates could have caused our catch-up position to fall outside of our corporate policy. The low interest rates resulted in a significant increase in the number of sensitivity runs performed to provide management with the best analysis possible when making decisions. In support of this need, Jeff and his staff completed several unscheduled sensitivity runs and responded to numerous requests for information.[131]

Although this performance appraisal was for the prior year (2002) it supports OFHEO's contention that the Enterprise processed multiple sensitivity runs in order to "reach results." **This strongly suggests that amortization expense was being actively and inappropriately managed by the Enterprise.**

A: I wouldn't relate it to the variability, economic variability, because what we were attempting to do was calculate a zone of estimation error, if you will, within which any number we produced we would view as the functional equivalent of zero – could not differentiate between whether $70 million is the right number or minus $50 million is the right number. That was the theory and intent behind the policy.

[131] Employee Contribution Review Form for Mr. Jeffrey Juliane for the period January to December 2002. The appraisal was provided by Mr. Richard Stawarz and approved by Ms. Janet Pennewell and is dated March 18, 2003. FMSE 220368-22073.

Management Discretion Applied in the Selection of Market Rate Assumptions

Appendix I "Estimation Methods Used for Modeling the Catch-up" provides an analysis of estimation methods selected, and their impact on the catch-up. The appendix also provides an analysis of assumptions selected in 1999 and 2000 by management that were used in the determination of the catch-up. OFHEO believes that the estimation methods selected, as well as market rate assumptions applied during this period, were consistent with an intent to avoid volatility and achieve desired financial results. **OFHEO also believes there are other noteworthy instances in which management selected assumptions, in periods subsequent to 2000, in order to produce desired financial results as well.**

Noteworthy in particular is the calculation of the June 2003 amortization. First, in this period, rates had declined sharply during the quarter. This rate decline precipitated a significant amount of discussion on how it should be addressed insofar as the modeling of the deferred price amortization was concerned.[132]

During testimony, management indicated that due to the timing of the rate setting meeting, it was common that the rate might be updated prior to quarter-end.[133] Due to the steep decline in rates, an analysis was performed to determine the most appropriate rate path to use for the June 2003 quarter-end sensitivity analysis. As a result of the analysis, management decided that it would be best to use a "hybrid rate" in order to calculate the amortization for that quarter.[134] The hybrid rate would be a combination of the current rate curve and the forward curve run as of April 30, 2003.[135]

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[132] Memorandum prepared by Mr. Jeff Juliane, Re: Amortization, June 11, 2003, FMSE-SP 000166-000167, in which he discusses 3 different interest rate scenarios and their expected impact on the Net Interest Income and Guarantee Fee catch-up position as of 6/30/03, 9/30/03, 12/31/03 and 12/31/04 compared to the respective thresholds.

[133] OFHEO Interview, Mr. Jeff Juliane, June 8, 2004, p.34
A: In Q2 there was a significant rate move after the rate setting meeting that came out. So we had a subsequent meeting with the rate setters and we came up with an adjusted rate path that they felt was the more prudent rate path to deal with because rates had been so substantial.

[134] OFHEO Interview, Mr. Jeff Juliane, June 8, 2004, p. 56
A: We felt it prudent that we needed to adjust our interest rate forecast because taken into the effect that rate reduction and then management had discussions around whether we should use like the May 15 floor or some other floor or what was an appropriate long-term rate associated with that historically low short-term perspective and they came up with this hybrid approach of getting back to the April 30 forward long-term perspective over a seven-month time horizon--6 month time horizon.

[135] Memorandum prepared by Mr. Jeff Juliane, Re: Amortization, dated June 11, 2003, FMSE- SP 000166-000167 states "Management elected to determine the impacts in considering the move down in rates as a "temporary shift" in the curve from the rates of April 30th. A third rate curve was modeled which we consider as a "hybrid" of the two runs. The "hybrid" rate path started at the May 28th current coupon rate, which was 50 basis points lower as compared to the April 30th forward rate, reverting back to the April 30th curve by the end of October. The curve was then consistent with the April 30th curve from that point forward."

The hybrid rate would consider the recent decline in rates, but at the same time assume a return to the April rate level over a short period of time. The net amount of the total catch-up position at that point was a deferred income amount. The change to the hybrid rate had the effect of increasing the amount of deferred income and thereby increasing the amount available for income recognition in the future.

The rate that was originally used for that quarter was previously determined at a meeting in April of that year. Subsequent to that meeting, rates suddenly dropped by approximately 50 basis points. The effect of the rate change on the catch-up level was analyzed in a memorandum dated June 11, 2003 from Mr. Jeff Juliane. The following table is an excerpt from that analysis:

4/30/2003 Forward Curve Run

Date	NII Catch-up	1% of NII Revenue Target	Gfee Catch-up	2% of Gfee Revenue Target
6/30/2003	$190.2	$99.6	$77.6	$44.4
9/30/2003	$142.0	$99.6	$81.3	$44.4
12/31/2003	$112.8	$99.6	$83.2	$44.4
12/31/2004	$68.2	$108.5	$90.0	$47.7

Down 50 Run

Date	NII Catch-up	1% of NII Revenue Target	Gfee Catch-up	2% of Gfee Revenue Target
6/30/2003	$216.0	$99.6	$174.3	$44.4
9/30/2003	$138.7	$99.6	$192.5	$44.4
12/31/2003	$99.4	$99.6	$204.6	$44.4
12/31/2004	$8.6	$108.5	$231.2	$47.7

Hybrid run

Date	NII Catch-up	1% of NII Revenue Target	Gfee Catch-up	2% of Gfee Revenue Target
6/30/2003	$217.3	$99.6	$92.1	$44.4
9/30/2003	$158.0	$99.6	$100.2	$44.4
12/31/2003	$129.4	$99.6	$102.4	$44.4
12/31/2004	$92.6	$108.5	$106.7	$47.7

Tables from memorandum dated June 11, 2003 from Jeff Juliane to Distribution. Subject: Amortization, FMSE -SP 000166-000167

The first table labeled "4/30/2003 Forward Curve Run" shows the amount of catch-up position using the interest rates from the April forecast.

The second table labeled "Down 50 Run" shows the amount of the catch-up position using the revised interest rate from a date in early June of 2003.

The third table labeled "Hybrid Run" shows the amount of the catch-up position using the revised interest rate from a date in early June combined with an assumption of a return to the April 30th rate level by the end of October 2003.

It is important to note that in all these rate scenarios, management's analysis included a *projection* of how it would affect future periods. This is consistent with emphasizing the forecasting and management of the catch-up over prospective periods.

The different dates on the tables reflect the forecasted trend in the catch-up position based upon the forecasted interest rate and prepayment assumptions assuming no future change in market conditions. In all three scenarios, the amount of the deferred income for NII was forecasted to decline and the amount of the deferred income for Guarantee Fee was forecasted to increase.

A Bloomberg printout obtained from Enterprise management shows that the decrease in rates from April was a temporary decline, and that rates actually rose towards the end of June. The low point of rates for the quarter actually occurred on June 12, 2003, one day after the date of Mr. Juliane's rate analysis.[136] Coincidentally, this curve was the most advantageous rate curve possible. Had the analysis been re-run using the June 30 rate estimates, it is likely that the catch-up amounts would not have exceeded the respective thresholds and no income on-top adjustments would have been required or the amounts of the on-top adjustments would have certainly been lower.

Why the Hybrid Rate was Advantageous

The hybrid rate was attractive for two reasons: (1) the incorporation of the rate decline provided more income that could be recorded as compared to the income that could be recorded using the April rate and (2) the hybrid rate provided less income than the "Down 50" scenario. This allowed management to record some income, but not so much that the catch-up position would become negative, if rates changed adversely in subsequent periods. To this extent, the hybrid rate presented a "Goldilocks" solution: it was not too high, not too low; it was just right.

In addition, the Enterprise was in the process of correcting certain errors that had been discovered in the data used to calculate amortization. For instance, securities that were purchased at a premium were erroneously included in modeling groups with securities purchased at par or at a discount. The reason that including them together was incorrect is due to the fact that securities purchased at a premium do not respond to changes in interest rates in a similar manner as those purchased at a discount.[137] The correction of these misclassifications was being done pursuant to a project known as "Security Master."

Beginning in the first quarter of 2003, the Enterprise began modeling the effects of the Security Master project. This was important because the potential adjustments resulting from the project could have a significant effect on the amount of accumulated amortization. Specifically, the changes were likely to result in large amounts of catch-up adjustments. As the modeling

[136] Bloomberg screen print, FMSE 194295-194296
[137] SFAS 91, Q&A 51

progressed, it became clear that the adjustments resulting from the Security Master project would result in a negative (expense) catch-up adjustment. This recognition was acknowledged by the inclusion of the projected expense as one of the reconciling items in the amortization results memorandum prepared for the quarter ended June 30, 2003.[138]

Because the Security Master project was expected to result in a large expense adjustment, it was monitored closely so that the final effect could be absorbed into the catch-up position when the project was completed without having an adverse effect on reported earnings.

The projected expense resulting from Security Master is also a reason why the "Down 50" rate scenario was not advantageous as of June 30. If too much income was taken in June, then there might not be enough unrecorded income in the catch-up position to absorb the expense resulting from the corrections identified by the Security Master project in the following quarter when the project was expected to be completed. This is another example of how the catch-up framework was used as a "cookie-jar" to mitigate forecasted expenses.

In her testimony Ms. Janet Pennewell described a point in the formulation of the policy in 1999 where the concept of a mean reversion technique was considered.[139] Mean reversion is a concept whereby forecasts of long-term interest rates are assumed to always revert to a mean interest rate level. Ms. Pennewell indicated that the Enterprise chose not to implement the mean reversion technique because they did not feel that such a technique was permissible. Ms. Pennewell further elaborated that it was her personal belief that such a technique (if employed as a matter of policy) could lead to even greater volatility. For instance, if rates fell, the mean reversion technique could slow down the rate of change in the amortization speeds. However, if rates did not revert to the mean shortly thereafter or continued to fall a large amount of catch-up adjustment could result.[140]

Although the hybrid rate did not technically constitute a mean reversion technique, in fact, it had an analogous effect. The current rate path was only used for the next few months and expected to revert back to the April 30th rate curve within a 4 month period. The flexibility to apply discretionary judgment to selecting interest rate assumptions and modeling rate curves provided much more favorable results than mandating certain rate scenarios by using the

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[138] Memorandum prepared by Mr. Jeff Juliane, Subject: Q2 Amortization Results, July 29, 2003, FMSE 023763-023765.
[139] Memorandum prepared by Mr. Jeff Juliane, Subject: Amortization Policy Runs, to Mr. Tim Howard, June 21, 2000, FMSE-SP 000024-000025, in which he discusses various scenarios showing "sensitivity results using mean reversion to generate the prospective cashflows."
[140] OFHEO Interview, Ms. Janet Pennewell, June 15, 2004, pp. 176-177.
Q: [...] In this discussion of this alternative, the effect of assuming that rates will trend back down towards a historical average, that would have the effect of reducing earnings volatility, correct?
FANNIE MAE LEGAL COUNSEL: Would or did? Because this was done –
Q: Would.
FANNIE MAE LEGAL COUNSEL: Hypothetically.
Q: Hypothetically, it would.
A: I actually don't think it would. The proponent of that particular view thought that it would help reduce the arbitrary earnings volatility that we've talked about before. In fact, I was of the view that, in fact, it would increase the potential, in certain circumstances, for additional volatility and, more importantly, I was concerned that if rates continued to, over a sustained period of time, continued to [sic] move away from historical means that you could very quickly develop a large catch-up, and that was never our objective.

concept of mean reversion. As this circumstance shows, management had the latitude to determine whatever interest rate assumptions it desired.

Capitalization and Amortization of Reconciliation Differences

Limitations in systems integration and application level controls undermined the integrity of information used to estimate amortization. This necessitated periodic reconciliations between information on transaction sub-ledgers (i.e. STATS, LASER) and the information on the amortization sub-ledger (iPDI). Differences from these reconciliations are known to Fannie Mae personnel as "realignments." On some occasions, these differences were recorded as adjustments in the period in which they became known. On other occasions, these differences were capitalized as phantom assets or liabilities and amortized over a period of time using the life of a proxy security.[141] Amounts capitalized in this manner were placed in a separate account in the PDI sub-ledger which was commonly referred to as the "deferred pool bucket" or the "bucket". Management of the Enterprise refers to such reconciliation differences as realignments.[142]

This practice was well known within the Enterprise. In their July 9, 2003 audit report on Amortization, the Office of Auditing included the following statement (referring to reconciliation differences):

> Management's practice has been to expense smaller differences, to book and amortize larger differences as new acquisitions, or incorporate the differences into the overall catch-up balance.[143]

In addition, Ms. Joyce Philip provided the following background on the above observation:

> Q: Did audit inquire as to whether the alternative treatment of expensing smaller items and amortizing larger items was consistent under GAAP?
>
> A: We raised-we discussed this with Jonathan [Boyles] to determine whether any one of these treatments was appropriate. And Jonathan indicated that he had no concern with either one of the methods. But he did agree that there should

[141] OFHEO Interview, Mr. Jeff Juliane, June 8, 2004, pp. 137-138.
Q: Is – what is the amortization characteristic of balances that are assigned to the bucket?
A: We assign a conventional proxy for the amortization flow of those bucket acquisitions.
Q: "Conventional" meaning 30-year fixed rate?
A: Yes.
Q: That would be true even though originally the amount assigned to this bucket may have come from a pooled mortgage that – pooled mortgages that was not 30-year fixed rate?
A: That's correct. I mean, the color of the elements of our asset is 30-year fixed range [sic: should be rate]. The specific answer to your question is you're right.
[142] OFHEO Interview, Mr. Jeff Juliane, June 8, 2004, pp. 82-83.
Q: [...] So what is the deferred pool bucket comprised of?
A: When we have--when we do--the deferred pool bucket is where we do realignments. We have a realignment policy that states that amounts above a certain threshold are put in the deferred pool bucket and given the proxy factors that amortize it over the life of that proxy collateral, and--but the amount is fully incorporated within the framework of the policy in times of catch-up.
[143] Fannie Mae Office of Auditing Report, Amortization Audit, July 9, 2003, FMSE 023745-023752.

> be consistent direction or procedures as to how, going forward, realignment differences should be treated.[144]

In his testimony, Mr. Boyles claimed no recollection of that discussion.[145]

There is no justification in GAAP for capitalizing and deferring differences resulting from reconciliation differences. Also, the effort involved in performing these reconciliations, and the magnitude of the differences, suggests that meaningful weaknesses in internal controls and system deficiencies had existed in previous years.

The following is an illustration of how the practice of transferring differences into the bucket would work: For example, a security is purchased with a premium of $10, a purchase price of $ 110 and $100 redemption value. Six months later the systems are realigned and the premium, which was originally recorded at $10, is adjusted to $5. As such, the amortization that has occurred to date is roughly twice as high as it should have been. Rather than recording an adjustment to income as they should have, Fannie Mae moved the difference to the bucket and amortized it using a proxy estimated life.

According to information OFHEO received during the examination, the practice of capitalizing reconciliation differences dates back to 1991. The last significant LASER reconciliation difference added to the bucket was a deferred income of approximately $27.8 million in April of 1998.[146] Most of the older amounts in the bucket relate to LASER realignments and were for the most part fully amortized as of June 2002. The total net composition of the bucket as of June 2002 was a deferred credit balance of approximately $43 million.[147]

The first STATS realignment, however, was performed in August of 2002[148] and the resulting difference was also recorded as a "new acquisition" into the bucket. This accounting practice was described in the Office of Auditing Amortization Audit Report, dated July 9, 2003, as one of their audit observations regarding processes that "should be improved to provide better documentation of analyses supporting G/L activities"[149] as follows:

> Data Processes:
> Because of systems and process limitations, reconciliation differences exist between the amortization account sub-ledgers (STATS and LASER), the G/L, and the amortization subledger (PDI). For this reason, the various systems need to be periodically realigned, resulting in adjustments to original unamortized accounts and accumulated amortization account balances.

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144 OFHEO Interview, Ms. Joyce Philip, July 21, 2004, p. 91.
145 OFHEO Interview, Mr. Jonathan Boyles, August 24, 2004, pp. 97-98.
Q: Okay. Have you ever rendered an opinion that it would be appropriate to capitalize and amortize reconciliation differences at any point?
A: I don't remember ever giving an opinion as relates to that.
146 Subsidiary G/L Account by Acquisition Date, Month Ended: March 2002, FMSE 193570.
147 *Id.*
148 Subsidiary G/L Account by Acquisition Date, Month Ended: September 2002, FMSE 193572, shows an addition to the STATS realignment product type in August of 2002 for approximately $46 million.
149 Subsidiary G/L Account by Acquisition Date, month ended: June 2002, FMSE 331640

> These adjustments ranged from $700 thousand to $45 million during the period 11/2002 to 5/2003. Management's practice has been to expense smaller differences, to book and amortize larger differences as new acquisitions, or incorporate the differences into the overall catch-up balance.[150]

The following table shows significant STATS realignment amounts that were transferred into the bucket since 2002 and the total net balance of the bucket as of March 2004:

Composition of the Bucket as of March 2004
Deferred Debits (Credits)

August 2002	$	(15,102,606)
May 2003	$	(40,183,296)
August 2003	$	63,951,446
February 2004	$	105,915,406
Other (Net)	$	(25,697,089)
Total	$	88,883,861

Source: Subsidiary G/L Account by Acquisition Date: For Original Amount: Deferred Debits (Credits) Month Ended March 2004 (G/L Account 1201-01) FMSE 193584

The amount shown on the schedule above for February of 2004 relates to a different error in the amortization process. OFHEO understands that the $105 million amount was subsequently revised to an amount of only $36.5 million.[151] Management of the Enterprise informed OFHEO that the amount of this $36.5 million realignment was later reversed and recorded as an expense in the month of March.[152]

The error related to a system problem in handling dollar roll transactions. In a dollar roll transaction, securities are lent out of the portfolio in secured financing arrangements. The error occurred when, upon return of the collateral, the original acquisition date of the security was overwritten with the date the security was returned to the portfolio. Such a date change caused issues with the accounting for amortization since the original acquisition date was needed to estimate the period of amortization.

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[150] *Id.*

[151] Fannie Mae Reasonableness Test of Purchase Discount Income, for month ended March 31, 2004, FMSE-SP 003313.

[152] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, p. 181
Q: If I understand this correctly, then at the end of that same corridor [sic quarter], Q104 [sic Q1 04], you were within the threshold for NII, but a debit was booked –
A: For $36,515 [sic].
Q: Right. What did that amount relate to?
A: That related to the dollar-roll realignment that Financial Standards determined that was an error. We did a SAB 99 on it, and we booked it. We just happened to use that account booking. It wasn't an on-top based on policy. That's the account that we chose to recognize the expense related to this dollar-roll error.

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The final amount of the adjustment was determined by correcting the data in the STATS system and then determining the impact of the corrected information. Mr. Juliane specifically referred to the dollar-roll realignment as "non-standard."[153]

A formal SAB 99 analysis was prepared on the error including an evaluation of what effect the error had on prior periods, earnings per share, employee award calculations and other measures. This analysis was performed by the Financial Standards group at the request of Ms. Spencer.[154]

It should be noted that the analysis completely ignores the Enterprise's prior practice of capitalizing differences and amortizing them over proxy periods. **While the memorandum recommends that the results of the analysis should be shared with management, any comparison to the Enterprise's realignment policy is noticeably absent.[155]**

The recording of this error as an expense is in direct contrast to the treatment of past differences. In addition, it is not in conformity with the Enterprise's policy for recording realignments into the bucket. Management of the Enterprise indicated that going forward all non-standard realignments will be evaluated by Financial Standards before they are recorded.[156]

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[153] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 181-182.
Q: What differentiated that dollar-roll error from, let's say, a realignment?
A: That would be a question for Financial Standards because we engaged them on this realignment, and I provided analysis to their group, and they did a determination, whether it was a change in estimate or an error.
Q: When did that occur?
A: End of March. You'll see a Q1 memo for 2004, there's an attachment of Nicole's [sic. Mukul's] analysis of whether there was an error or not in the materiality relating to previous periods.
Q: I thought that was for dollar rolls and not for realignments.
A: No, it was a realignment due to the fact that we determined that we determine there was a dollar-roll error inside of STATS. So this was the processing of changing the original un-ams associated with the fact that there was a dollar-roll error, and that's what Nicole's [sic. Mukul's] analysis is all about.
Q: Does that mean that future realignments will no longer be capitalized into the bucket?
A: No. Once again, when you see our SOX documentation, we have a formalized realignment policy that says that standard realignment differences will be handled in the same fashion that they're currently being handled. Nonstandard realignments will be run through Financial Standards to determine the proper handling of the accounting associated with that.
[154] OFHEO Interview, Mr. Jonathan Boyles, August 24, 2004, pp. 83-84.
Q: Referring back to, I guess, audit difference related to dollar rolls, we saw an analysis that was done by someone who worked for you named Mukul Gupta?
A: Yes.
Q: And he evaluated the error in context of many periods and many different things, basically a SAB 99 analysis. Who directed him to perform that analysis?
A: I don't recall who it was in particular, but either Janet or Leanne. My best guess would be Leanne. In one of my meetings with her, one of my regular meetings with her, described this issue and asked me to perform the analysis. And so I obtained the information from Janet Pennewell's group and Mukul did the detailed analysis and reported up through me.
[155] Memorandum dated May 3, 2004, from Mukul Gupta to Distribution, Re: Error in Amortization of Securities Used in Dollar Rolls, FMSE-SP 000268.
[156] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, p. 182.
A: [...] Once again, when you see our SOX documentation, we have a formalized realignment policy that says that standard realignment differences will be handled in the same fashion that they're currently being

Our examination has not seen any evidence to indicate that the errors on dollar rolls are any different than other types of errors that have an effect on the accounting for amortization.

OFHEO believes that the expense was taken for two reasons: (1) there was a large income on-top adjustment required for Guarantee fee amortization at the end of the first quarter of 2004 which more than offset the amount of the expense resulting from the recording of the dollar roll error, and (2) changes in interest rates projected that the net interest income catch-up position would grow negative by the end of the year. If correct this conclusion would be consistent with the intent to maintain the catch-up amount in a deferred income position.

Accounting for the Correction of an Error

The relevant accounting guidance for the treatment of the reconciliation differences can be found in Accounting Principles Board Opinion 20, *Accounting Changes* (APB 20). APB 20 provides the following guidance about why matters such as the reconciliation differences should be considered errors:

> Reporting a correction of an error in previously issued financial statements concerns factors similar to those relating to reporting an accounting change and is therefore discussed in the Opinion. Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment. Thus, an error is distinguishable from a change in estimate.[157]

APB 20 also provides guidance on how corrections of errors should be recorded in the financial statements:

> The Board concludes that correction of an error in the financial statements of a prior period discovered subsequent to their issuance (paragraph 13) should be reported as a prior period adjustment.[158]

Although the guidance above would indicate that the adjustment should be shown as a prior period adjustment, the SEC issued Staff Accounting Bulletin Topic 5F which provides the following additional guidance with respect to the correction of immaterial errors:

> If prior periods are not restated, *the cumulative effect of the change should be included in the statement of income for the period in which the change is made* [Emphasis added] (not to be reported as a cumulative effect adjustment in the manner of APB Opinion 20). Even in cases where the total cumulative effect is

handled. Nonstandard realignments will be run through Financial Standards to determine the proper handling of the accounting associated with that.

[157] APB No. 20: Accounting Changes, Par 13.

[158] *Id.*, Par. 36

not significant, the staff believes that the amount should be reflected in the results of operations for the period in which the change is made.[159]

Based upon the guidance above, OFHEO has concluded that the practice of capitalizing and deferring these reconciliation differences is not permitted under GAAP. In addition, the Enterprise's practice of treating reconciliation differences in one of three ways (expense, capitalize or include in catch-up position) demonstrates yet another manner in which inconsistent decisions were made by management that affected the recorded amount of amortization.

Inconsistent and Incorrectly Applied Accounting Practices to Determine the Catch-Up

OFHEO's examination identified a number of instances whereby the catch-up results were changed by including adjustments that were incorrect or inconsistently applied.

During 2003, certain of the reconciliation differences started being included in the catch-up analysis for NII. However, not all reconciliations were included. The inclusion of reconciliation differences in the catch-up framework is inappropriate for a number of reasons:

- According to management, the catch-up sensitivity analysis is necessary due to the range of uncertainty in estimating prepayments. However, the inclusion of such adjustments (which result from errors created by system limitations and other items) to the results of the catch-up sensitivity analysis is fundamentally inconsistent with this line of reasoning.

- Certain modeled future reconciliation amounts – modeled pursuant to only one interest rate scenario - were included as adjustments to different catch-up sensitivities. Even management of the Enterprise pointed out to us that this would not make sense since the catch-up sensitivity is based upon the mean of five interest rate scenarios while the estimated impact of the future reconciliation amounts is based upon only *one* interest rate scenario.[160]

- Management of the Enterprise used discretion to select which amounts to include as adjustments to the catch-up on a quarterly basis.

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[159] SEC Staff Accounting Bulletin Topic 5F: Accounting Changes Not Retroactively Applied Due To Immateriality.
[160] OFHEO Interview, Rene LeRouzes, July 16, 2004 p. 144
Q: Three hundred and ninety-three million. So if you had run catch-up sensitivities as of that date, the 393 million would have been the net impact that using an updated factor after-affecting the MBS reclass would have on catch-up?
FANNIE MAE LEGAL COUNSEL: Q: Can you tell him what that number is?
A: That number – a sensitivity analysis of five rate environments, a base and two outliers up and down. This [the $393] is only reflective of one environment. So to confuse this with a sensitivity analysis would be apples and oranges, from my perspective.

The catch-up calculation for the first quarter of 2003 was the first one to include the effects of reconciliation differences. The adjustment was actually made for the effect of a future realignment related to the Security Master Project. Alternatively, no adjustment was made for past reconciliation differences. The following description of the Security Master project was included in the Q2 2003 Amortization Results Memorandum:

> Security Master is an attribute level identification process that ensures consistent handling of collateral by assigning the FAS 91 type and associated general ledger accounts based on the actual security characteristics. These attributes are compared against rule-based tables within STATs [sic] to assign the appropriate set of accounts and FAS 91 designation. The rules are defined by the business users and maintained within STATs [sic].[161]

The result of the project would be that securities that had previously been included in inappropriate modeling types would now be included in modeling groups based upon objective criteria. Prior to the implementation of Security Master, the process of identifying securities had been done manually by the trade input area.[162] The two significant issues that were supposed to be resolved by Security Master were as follows: 1) certain securities purchased at a premium had been included with securities purchased at par or at a discount. This was not appropriate because (as described in this report) prepayments on securities purchased at a premium were not affected by changes in interest rates in a similar manner as securities purchased at a discount; and 2) certain REMIC tranches[163] were inappropriately grouped together for modeling purposes as well (for example, premium and discount REMICs were commingled).

The reason that Security Master was going to have a large effect on the financial statements was due to the fact that, after the securities would be transferred, catch-up would be recorded (comparing the new life-to-date calculation to the previously recorded amounts) and any errors in the previous calculation would cause significant swings in the catch-up balance.

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[161] Memorandum prepared by Jeff Juliane, Subject: Q2 Amortization Results, dated July 29, 2003, to File, FMSE 023763-023765.

[162] OFHEO Interview, Mr. Rene LeRouzes, July 16, 2004, pp. 147-148.

Q: So this analysis that we just looked at, that was – that showed the dollar effect of the MBS reclass. Was there an analysis prepared to show any dollar impact of the REMIC remapping?

A: Not that I worked on. No.

Q: Do you know, in fact, whether or not the REMIC remapping did have a dollar effect on the catch-up or on the amortization?

A: Yes, it had – it had an impact. But I don't know what that was and, sitting here today, when that analysis was integrated with this one. If it was, in fact, done, but I would think it would have been.

Q: Would it be possible for you to explain to us why that – what generated that impact?

A: What impact?

Q: The impact of the REMIC remapping?

A: The REMIC remapping was a rule-based engine that provided instead of manually determined concepts at the cohort level, the rule-based engine for securities, specifically the MBS reclass and the REMIC project, made the actual process as best as it could be. So there was no manual tagging done at the trade level to determine FAS 91 types. It was an automated approach to provide increased data integrity.

[163] Risk, maturity or other classes into which a multi-class security such as CMO or REMIC is split.

An amount of $118 million was deducted from the amount of the NII catch-up position as of the first quarter of 2003. In addition, there were four sensitivity analyses run for the first quarter of 2003[164] which calculated a positive catch-up (income position) ranging from $175 million to $232 million.

The impact of the Security Master was actually modeled twice (presumably for purposes of estimating the effect it would have on the catch-up). The first analysis was done using the existing (in-use) factors. That analysis showed that the Security Master Project would result in an estimated $118 million expense amount.[165] The second analysis was done using the updated (March 2003) factors and showed that the project would result in an estimated $393 million amortization expense amount.[166]

Management decided to rely on the analysis using the older rates. This was important for two reasons: 1) Had the analysis using the newer rates been used, the inclusion of the $393 million amount in the analysis of catch-up would have required management to record an on-top expense adjustment of roughly $62 million (using even the most advantageous catch-up based upon the 4 scenarios run).[167] In addition, that would have left the catch-up position in a negative $99 million (deferred expense) position, the least advantageous position under the policy. 2) The catch-up position (based upon the final calculation) exceeded the threshold by approximately $78 million. By including the lower amount, no on-top adjustment was necessary because the catch-up was now within the range of +/- 1% of portfolio NII.

Even though the adjustment for the Security Master project related to prior periods, it should be noted that an assessment of the impact of the project on prior reporting periods was never performed. However, in the first quarter of 2004, a comprehensive assessment was done for the amortization errors related to dollar rolls. This is interesting, especially due to the magnitude of the potential Security Master Project adjustment.[168] In the instance of the dollar roll error, management concluded that the $36.5 million impact was immaterial.

The final catch up calculation prepared for the quarter ended June 2003 showed a total catch-up position of $220.5 million. However, the impact of Security Master had grown to be $155 million as of June 30, 2003. It is interesting to note, however that the amount of the impact had not been re-modeled (as would be necessary to appropriately reflect the updated rate

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[164] The four sensitivity analyses referred to are labeled FMSE-SP 002926, FMSE-SP 002930, FMSE-SP 002942 and FMSE-SP 002943.
[165] MBS Reclass Summary Update, FMSE-SP 000155-000156.
[166] *Id.*
[167] $232-393=-161. With a catch-up threshold of approximately 99 million as of March 31, 2003, an on-top adjustment of approximately $62 million ($99-161) would have been required under the Enterprise's policy.
[168] OFHEO Interview, Mr. Jonathan Boyles, August 24, 2004, p. 86.
Q: I'm just curious. Why prepare a SAB 99 analysis for this particular item and not, for instance, for the security master items?
A: Again, I'm not on the day-to-day, you know, feed on what's happening down in the purchase discount area. When I'm asked to perform it, I perform it. I'm not aware of other issues or other concerns that Leanne would have thought would have required a SAB 99. So, you know, what she will do will she'll ask me or, you know, here's something that we think we might have missed. You know let's evaluate it. And so she asked me to do it, and I would not have even known about the dollar roll if somebody didn't bring that to my attention and ask me to perform it.

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environment). Instead, an amount of $37 million was simply added to the original $118 amount. The $37 million was the estimated impact that moving those securities (that had an estimated impact of $118) would have on the other securities that would still remain in their original modeling entities. Management of the Enterprise indicated that this amount had been more difficult to isolate and to model, and that is why this number was not determinable on the same date as the $118 million amount.[169] It is not clear why the $118 amount was not updated, especially since there had been such a wide range of possible outcomes ($118-$393) using the data from the first quarter.

The amortization catch-up results for the second quarter of 2003 were also adjusted to take into account certain reconciling items. The inclusion of reconciling items was identified as an observation in the internal audit report.[170] That report noted that there were no standards specifying which reconciling items should be included.[171] The reconciling amounts were related to certain realignments arising from the STATS system. However, reconciliation differences from the LASER system were ignored. Management of the Enterprise has not offered any credible explanation for why only certain items were included.

The amounts included as reconciling items in the catch-up analysis performed for the second quarter of 2003 were deferred credits which totaled approximately $60 million increasing the mean catch-up position from $ 220.5 million to approximately $ 280.5 million.[172] The actual net amount of deferred reconciliation differences as of that date was, however, $92.3 million.

This raises the question of why only certain amounts of the realignments were included in the reconciliation. Although our examination has not found specific evidence that the inclusion of only certain realignments at June 30, 2003 was done intentionally to achieve a particular result, the inclusion of the reconciliation differences did have a direct impact on the amount of the on-

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[169] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 104-105.
Q: Was that effect incorporated into the catch-up and the on-top, or was it included – was it treated similar to a realignment?
A: It was completely encapsulated in the framework of the policy. There's multiple stages of this thing. We did an analysis in Q1 to determine the 118 [million]. Then there's an analysis that we – we enhanced that analysis because when you're moving collateral out of a FAS 91 type and into a FAS 91 type, there's going to be ancillary effect to the assets that remain in the old FAS 91 type because you're altering the cash flows. So we went in and as we enhanced our estimate over time, we said that 118 was the initial estimate that we have from just moving collateral X – collateral out of conventional into conventional premium.
We then said, okay, we didn't have time at that point in time in Q1 to do an analysis, so, okay, what's that going to do to the factor of the assets that are left behind in the conventional FAS 91 type, because theoretically you had just taken the higher-yielding assets, i.e., premium priced assets, out of conventional and moved them somewhere else. So you're theoretically going to slow down or lengthen the duration of the remaining assets in conventional. So we did that analysis in Q2, and we came up with an estimate of, I believe, $37 million that was going to be the impact of the catch-up related to the conventional acquisitions. At that point in time, our total estimate was $155 million related to the entire Security Master impact relating to MBS re-class. [...]
[170] Fannie Mae Audit Report, Office of Auditing, Amortization Audit, July 9, 2003, FMSE 023749
[171] *Id.*, the audit report states "[...] procedures do not specify what level of documentation is required to support actions taken, or what level of management involvement is required. Examples include: - Changes to modeling methodology [...], - Adjustments to Catch-up Results [...]."
[172] Memorandum prepared by Jeff Juliane, Subject: Q2 Amortization Results, July 29, 2003, to File, FMSE 023763-023765.

top adjustment recorded in that period. Essentially, by including the projected effect of the STATS realignment, management of the Enterprise had allowed the amount of catch-up to grow so that the impact of the errors to be corrected by the Security Master project could be absorbed in the period the project was completed while still maintaining a positive catch-up position. This is further evidence that the catch-up framework was not a range of uncertainty in estimation but rather a reserve that management could rely upon and offset against other adjustments.

Later, in September 2003, the net amount of *all* realignments was included as a reconciling item in the catch-up analysis.

The following table, taken from a draft of the Q3 Amortization Results Memorandum, shows the adjustments made to the modeled catch-up position for both the second and third quarters of 2003:

	Q2	**Q3**	**Difference (Q3-Q2)**
Mean Catch-up position on preliminary sensitivity report	$220.5	$298.1	$77.6 (a)
All realignments	$60.9	$82.8	$21.9 (b)
Back out catch-up from PO sales	$0	$(30.4)	$(30.4)
Modeling estimate of $1.3 billion MBS reclass	$(155.0) estimate	$(132.0) actual	$23.0
On-top recorded	$(21.2)	$(107.5)	$(86.3)
Ending Position	$105.2	$111.0	$5.8

(a) Difference due to higher rate environment. This caused the net premium book amortization speeds to slow relative to current in-use factors. This causes an increase in the overall income (over amortization of premium) position.

(b) Included the impact of all net LASER realignments for the Q3 sensitivity runs. This caused an additional 21.9 million of positive catch-up to included [sic] into the analysis.

Q3 Amortization Results Memorandum draft dated October 22, 2003; FMSE-SP 000377.[173]

There are a few things to note about the realignments included in the analysis above:

- The catch-up threshold is, according to management, meant to serve as a measure of the range of uncertainty in estimating prepayments. Conversely, the realignment amounts relate primarily to known and quantified amounts that reflect the correction of processing errors.

[173] Although the memorandum dated October 22, 2003 is a draft, the amounts included in the table agree to a copy of the final memorandum dated as of the same date except that, in the final memorandum, the realignment amounts were included together with the mean catch-up amounts. See FMSE-SP 000576.

- There are differences between the manner in which included amounts have been calculated. The mean catch-up position is calculated using the simple mean of five different interest rate scenarios. Alternatively, the estimated impact of the MBS reclass as of June 30 ($155 million expense) was estimated using only one interest rate path. Lastly, the recorded realignment amounts ($62.9 and $82.8 for June and September, respectively), the amounts related to PO sales in September ($30.4 million) and the amount of the MBS reclass are actual *recorded* amounts. **This commingling of different reconciling items (with mixed bases of valuation) clearly shows that the catch-up framework devised by the Enterprise is a means for managing amortization expense and not, as management claims, a range of uncertainty in estimation.**

In addition, the balance of all realignments recorded to the bucket was $92.3 million and $20.9 million (both deferred credits) as of June 30, 2003 and September 30, 2003, respectively. Based on OFHEO's review neither of the amounts included in the table above agree to the balance of the bucket as of the respective dates.

The amount included in the table for realignments as of June 30, 2003 ($60.9 million) does not agree, because only certain realignment amounts were included, as previously discussed.

The amount included in the table for realignments as of September 30, 2003 ($82.8 million) also does not agree. Information about how the $82.8 million amount was derived is not clear at this point in OFHEO's examination. This amount appears to be included in error because the following month, only $19.4 million[174] of deferred income from realignments was included in the analysis of the amortization results despite the fact that there were no realignments between September and December of 2003.

However, management of the Enterprise did inform OFHEO that an amount of $67 million, which was recorded into the bucket in August of 2003, directly corresponded to the originally estimated amount of the Security Master impact of $118 million.[175] This means that the impact of Security Master had been included in the catch-up framework for three quarters, which directly impacted the amount of amortization recorded. However, when the project was completed and the impact was quantified, the amount was recorded as a new acquisition and amortized over a proxy (thirty year) life. **This clearly shows that the inclusion of certain reconciling items had the effect of shifting large amounts of income from one period to the next. Had the impact of Security Master not been included as an adjustment**

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[174] Memorandum prepared by Mr. Rene LeRouzes, Subject: Q4 Plan Amortization Results, dated January 30, 2003, FMSE-SP 000370.

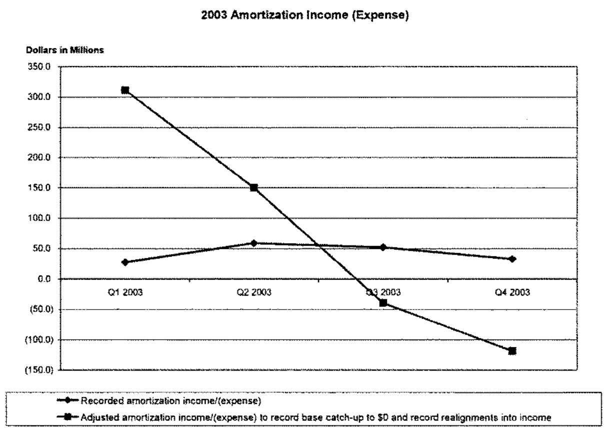
[175] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 114-115.

Q: [...] Do you recall what the purpose of including these reconciling items was?

A: My recollection as we sit here today is that we were trying to encompass all the different arenas where STATS had been – where issues between STATS and iPDI were impacting the results. So at that point in time, we had two of them through realignments and one through Security Master. So we encompassed all those things to look at – to come up with what we thought at that point in time was our best estimate of our catch-up position.

to the catch-up results beginning in Q1 2003, the amortization results for the year would have looked very different.

The following chart illustrates the difference between the amount of amortization recorded by the Enterprise during 2003 and the amount that would have been recorded if realignments had been recorded in income and if the catch-up (using the base rate forecast) had been recorded to $0 at each quarter end.



Management's decisions on how to include realignments in the catch-up evolved as follows:

Q1 2003: Include only the effect of the projected impact of the anticipated Security Master Realignment
Q2 2003: Include Security Master and certain other STATS realignments
Q3 2003: Include all realignments
Q3 2004: Continue to include all realignments

As described previously, in the first quarter of 2004, the Enterprise performed another reconciliation and corrected a known error in the accounting for Dollar Rolls. In that case, management first decided to capitalize the amount and later decided to expense it. So in the span of one year, the Enterprise has employed four different practices with respect to realignment differences. See section X for more discussion about the expensing of the Dollar Roll realignment.

OFHEO also identified other adjustments to the modeled catch-up amount that were either not approved by management or the amortization policy did not provide guidance on how to handle these adjustments:

- For the 4th quarter of 2002 and the 1st quarter of 2003 the modeled catch up amount was adjusted for the impact of new acquisitions. In the 4th quarter of 2002 this adjustment brought the amount of the catch-up position within threshold and therefore made the recording of an adjustment to amortization income unnecessary. The adjustments for the impact of new acquisitions on the book of business were not approved by management. The inclusion of new acquisitions in the modeling process is necessary because the book of business is generally on a two to three month lag;[176] however, this process is not documented and was not applied consistently.

- For the 3rd quarter of 2003 the catch up results for guarantee fees (as modeled by the system) were manually adjusted by $ 20 million. The adjustment was not disclosed on the catch-up sensitivity analysis report as a manual adjustment to the model results and therefore might not have been known and approved by management. Fannie Mae's Office of Auditing was able to obtain some support for the adjustment; however, the amount was based on judgment and therefore "not very intuitive".[177]

Internal Controls over the Amortization Process

During our examination, we noted a number of significant control weaknesses in the process of accounting for amortization. A majority of these internal control weaknesses are centered around the AIMS system[178] and the modeling process. Such findings have been made in spite of the fact that the Fannie Mae Office of Auditing (OA) completed an audit (which noted some issues but only issued a "yellow"[179] rating) of the amortization process as recently as July 2003 and had, in addition, performed other procedures subsequent to that date.[180] OFHEO believes

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[176] OFHEO Interview, Mr. Jeff Juliane, June 8, 2004, pp. 99-100.
Q: At some point, our understanding is that you began to incorporate – let me ask a question prior to that. The balances upon which the catch-up analysis is performed lagged by one quarter, so when – is that correct?
A: That is correct. There is a – when a book is presented four [sic. for] our consumption; that is, between 28 to 29 days after the months that is just closed so we always strive to stay on the same book as portfolio, so there is a two- to three month lag between the book of business remodeling versus where we're actually at from a calendar period.
[177] Fannie Mae Office of Auditing SDI, Amortization Audit, 2003, FMSE 118808-118811.
[178] AIMS - Amortization Integration Modeling System.
[179] The Office of Auditing "yellow" rating translates into a conclusion that "Controls need strengthening. Requires attention during the normal course of business."
[180] OFHEO Interview, Ms. Joyce Philip, July 21, 2004, pp. 158-159
Q: As a follow-up, I noted that Security Master was referred to in management's corrective action. As a follow-up to this audit, would you do a post implementation review of the Security Master Project?
A: We did do a post implementation review of Security Master.
Q: And what was the date of that work, roughly?
A: It would have been some time in the third of fourth quarter of '03.
Q: Would there have been an official audit report similar to the July 9th report?
A: There would have been a memo issued.
Q: And would there be work papers that support that memo?
A: Yes.
OFHEO Interview, Ms. Joyce Philip, July 21, 2004, p. 111

that the presence of these significant control weaknesses themselves, undermined the process of amortization to such an extent that the material accuracy of deferred price adjustment amortization could not be reasonably assured. The significant control weaknesses include:

- Insufficient segregation of duties and key person dependencies
- Modeling undertaken to produce desired results
- Underlying data issues, including illogical or anomalous amortization factors
- A lack of written procedures, supporting documentation and an insufficient audit trail.

Segregation of Duties and Key Person Dependencies

In July 2003 Mr. Jeff Juliane was promoted and given responsibility over both the modeling and accounting for amortization. Immediately subsequent to his promotion, a concern was raised regarding the segregation of these functions in a meeting on August 8, 2003. The meeting related to an Office of Auditing investigation into an employee's – Mr. Roger Barnes - concern over amortization factor anomalies, and Mr. Barnes' further allegation that amortization factor change adjustments had been made to cause actual earnings to more closely align with planned earnings (See subsequent sections of this report for more information on the Amortization Investigation).

The following appears under the heading "3) Discussion of the internal controls over amortization activities" in the minutes to the August 8th meeting:

> Sam [Mr. Rajappa, SVP Operations Risk, Office of Auditing] stated that a recent reorganization, that organized iPDI subledger process (Roger Barnes' team) under the AIMS modeling function (Jeff Juliane), weakens the segregation of functions between the modeling and PDI data processing and general ledger functions.

Despite the Office of Auditing report, and Mr. Rajappa's concerns over the reorganization, that very same paragraph of the August 8th meeting minutes states:

> Janet Pennewell responded that the previous segregation of duties was largely due to how the two systems and functions had been developed and evolved over time. She added that she did not see this segregation as a key control being that determining how much income or expense should be recognized (accomplished by AIMS system) and processing to the G/L (accomplished by PDI) would be uncommon [sic] across other accounting operations within the Company.[181]

Q: Okay. Our understanding is that on August 8, 2003, a meeting was held to discuss his allegations. Is that consistent with your understanding?
A: My understanding of the meeting of August 8th was to provide a status update to various parties within Fannie Mae of the results of the test work we had done up to that point in time.

[181] Summarized Minutes of the Meeting (8/8/03), Unamortized Balances and Factor Analysis, FMSE-SP 000080-000081.

It is clear that members of the Controller's staff had the ability to effectively ignore concerns about control weaknesses raised by the OA. OFHEO has not been provided with any information to indicate if the segregation issue raised by Mr. Rajappa has been addressed.

OFHEO has determined that Mr. Juliane was already responsible for: a) all amortization modeling, b) determining changes to amortization prepayment assumptions, c) specifying functional requirements for the system that supported amortization modeling, d) performing the quarterly catch-up analysis, and e) making adjustments to earnings that were made directly to the AIMS modeling system as factor adjustments. With the reorganization, Mr. Juliane was now responsible for the PDI data processing and general ledger function. The segregation of those functions previously served as an important check and control point in the amortization process. In fact, the factor anomaly concerns that were examined by the OA were observed through the PDI data processing and general ledger recording activities, and significantly, the allegation that earnings were being adjusted to align with plan, were being directed at Mr. Juliane himself. An underdeveloped audit trail additionally impeded the capability of the Enterprise to effect any meaningful review or oversight of the processes and activities that now collectively fall under his responsibility.

Modeling Undertaken to Produce Desired Results

The AIMS System -as designed by the Enterprise- has two primary functions: the calculation of the catch-up and the calculation of the amortization factors that are used to determine prospective amortization. The system has the functionality to model the amortization results using a variety of different scenarios. This provides management of the Enterprise with a "menu" of available options for calculating the amount of catch-up. For instance, the AIMS system has the functionality to model a variety of possible rate scenarios, prepayment speeds, prospective catch-up adjustments and other modeling parameters. This allows the system user to evaluate results generated under varying scenarios before determining which specific assumptions to use for quarterly reporting.

OFHEO has found that, on a number of occasions, multiple sensitivity runs were processed after the quarterly closing. In particular, these occasions included periods after the yearly close. This is curious because the model-ready book is generally based on a book of business that is anywhere from one to three months old.[182] As such, the catch-up sensitivity report could have been run well before the closing of the books at the end of these periods. It is furthermore not clear why performing multiple runs using different assumptions or parameters would otherwise be necessary at all. The Office of Auditing did not identify any systems performance issues that would have necessitated such multiple runs. Neither, did the Controllers Group, identify any

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[182] OFHEO Interview, Mr. Jeff Juliane, June 8, 2004, pp. 99-100.
Q: At some point, our understanding is that you began to incorporate – let me ask a question prior to that. The balances upon which the catch-up analysis is performed lagged by one quarter, so when – is that correct?
A: That is correct. There is a – when a book is presented four [sic. for] our consumption; that is, between 28 to 29 days after the month that is just closed so we always strive to stay on the same book as portfolio, so there is a two- to three-month lag between the book of business remodeling versus where we're actually at from a calendar period.

performance issues in the controls self assessment questionnaire that all business units are required to complete.

Underlying Data Issues

There were also significant differences between the source systems (e.g. STATS, LASER) and the amortization system (iPDI), regarding the original balances to be amortized. These differences were primarily due to limitations in the timing and quality of the data which was fed from the transaction subledgers to the amortization system. As previously noted in this report, the reconciliation of those systems occasionally led to large differences which the Enterprise capitalized as new acquisitions and amortized over a proxy life. In addition however, such realignments also led to manual adjustments made to the catch-up sensitivity analysis. These manual adjustments were sometimes inconsistently treated and were not always adequately documented or supported. Thus review or validation of them was difficult.

The Enterprise's method for recording on-top adjustments within AIMS was also manually effected as well. AIMS system functionality supported the ability to selectively update factors for certain products without affecting others. This was one means to effect on-top adjustments (recorded as factor changes). Such adjustments were judgmentally allocated to particular modeling groups. This process of adjustment and allocation is inconsistent with maintaining the integrity of loan and security level information and, at a minimum, makes analysis and review of the amortization results more difficult (See following on Factor Anomalies). In her testimony Ms. Ann Eilers, Director Office of Auditing, described misclassifications caused by system feeds as one of her biggest concerns surrounding the amortization process.[183]

A manifestation of the extent of underlying data issues is illustrated by an adjustment to the catch-up results that was made in the third quarter of 2003. The analysis of amortization results noted an adjustment of approximately $30 million to the calculation of the catch-up amount to correct for improperly determined amortization for three principal-only ("PO") mortgage securities that had just been sold, and upon which, incorrect gains on sale had also been determined. OFHEO is still evaluating this issue and its implications. However, in his testimony, Mr. Juliane acknowledged the inaccurate amortization, and further stated that a review of the accuracy of the amortization of securities sold had never been previously performed. Aside from raising questions as to why such a review was performed at this particular time (the adjustment allowed the Enterprise to stay within the catch-up threshold), it also raises further concern about the extent or magnitude of similar errors on other securities.[184]

[183] OFHEO Interview, Ann Eilers, Director Office of Auditing, July 23, 2004, pp. 45-46.
Q: What was your biggest concern personally about the control surrounding the amortization process?
A: We had some system feeds that were creating misclassifications. We had some policies and procedures that weren't documented, and we had some business area records that were not as well documented.
[184] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, p. 103.
Q: You did an analysis on gain/loss?

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Factor Anomalies

The AIMS system produces results that are illogical or that represent mathematical anomalies. These illogical or anomalous conditions include negative amortization factors and amortization factors greater than one. In theory, a negative amortization factor would cause a premium or discount to grow larger over time. A factor greater than one could potentially cause for example, a premium to amortize beyond the original balance to become a discount.

Management has asserted that such illogical and anomalous results derived from the aggregation of premiums and discounts as well as REMIC tranches with dissimilar characteristics, but that they did not translate into inaccurate financial statements. This explanation however implies, at a minimum, the presence of other potentially deeper issues regarding the aggregation of deferred price adjustments into incorrect modeling groups. In addition, it raises the question as to why edit checks and error reports on data processes did not prevent the illogical results and anomalies from occurring, or why the Enterprise was not able to sufficiently flag their existence or report their breadth.

The improper aggregation of premiums and discounts and the illogical results and anomalies themselves posed other internal control concerns because such issues made it virtually impossible to correlate the amortization results to the actual performance of the underlying loans/securities. OFHEO believes that management would have been unable to effect such a review. In addition, the full extent to which illogical results and anomalies did, in fact, cause inaccurate financial reporting is a focus of OFHEO's continuing examination.

Our examination has concluded that these factor anomalies were caused primarily by a lack of clear delineation of responsibility by management of the Enterprise. A breakdown clearly occurred between the business unit owners of the source systems and the personnel in the Controller's Department responsible for calculating amortization. Because neither party took responsibility for the quality of the data, amortization errors occurred. When questioned about responsibility for ensuring whether a loan or security was included in an appropriate modeling group, Mr. LeRouzes offered the following answer: "Well, it's not me."[185] This was further validated by Mr. Juliane.[186]

A: No, no. I did an analysis quantifying the CUSIPs that we're moving and passed it along. I mean, I – I don't know if we – from an institutional perspective if we looked at that or not. I don't know if STATS did an analysis or not.

185 OFHEO Interview, Mr. Rene LeRouzes, July 16, 2004, p. 30.

Q: I guess – okay, that's fine. From a functional perspective, would you know which functional area would be the owner of that process?
A: Of signing off of ALEX?
Q: Making sure that securities are going into the right cohort?
A: I really can't speculate on what functional area there would be responsible for that.
Q: Okay. But it's clearly not – clearly not your area?
FANNIE MAE LEGAL COUNSEL: Not him. Right.
A: Well, it's not me.

186 OFHEO Interview, Mr. Juliane, June 8, 2004 p. 68.

Q: So, the business unit owner of the system would be responsible for setting the rules?

Factor anomalies can occur in a variety of ways and for a variety of reasons. There are a few simple maxims that can be applied, however, to ensure that factor arrays are correct. Mathematically speaking, a graph of level-yield factor arrays should be curvilinear and downward sloping over time. Updates to factor arrays could shift the curve up or down, but the prospective array thereafter should assume a similar relationship. In addition, the sum of all factors in any given array should total to 1 (or 100% of the item to be amortized). Another example of a factor anomaly would be a negative factor (which technically should never occur except in the case of a retrospective adjustment.)

Ms. Mary Lewers, Vice President of Financial Accounting, was the supervisor of Mr. Barnes and the iPDI area (among other things) and, as such, was ultimately responsible for the amounts recorded to the general ledger. She provided the following example of how such anomalies could occur:

> Question: How can you get a correct answer with a negative amortization factor?
>
> Answer: My understanding is that in total, when you combine all of the related information that you get to the same answer. It's just the pieces have this appearance to them that makes it difficult to analyze, but that fundamentally the amortization and the creation of factors is occurring at the REMIC level, which is the right level in terms of calculating the level yield.

Her response reflects two recurring themes about factor anomalies that we have encountered in our examination: 1) Personnel in the Controller's Department accepted the fact that factor anomalies existed and 2) Ms. Pennewell and Mr. Juliane continuously offered the same explanations as to *why* factor anomalies could occur, while always managing to avoid the larger question of whether such anomalies represented errors.

The question of whether such anomalies represented errors did not get addressed until the concerns raised by Mr. Barnes precipitated the Office of Auditing Amortization Investigation. **OFHEO has concluded that factor anomalies, in certain cases, do in fact represent errors and may also constitute departures from GAAP.**

According to direct testimony received in our examination, there appears to be a critical control point between the AIMS and iPDI systems that would identify any factor anomalies.[187]

A: They are responsible for insuring the light [sic, "right"] collateral on assets are getting put in the same FAS 91 types.

[187] OFHEO Interview, Mr. Roger Barnes, September 1, 2004, pp. 115-116.

Q: Why would AIMS not calculate the right amount of the current month's amortization if it had the factor with it generated and if it had received the balances from PDI?

A: The way AIMS was structured, and I am not the expert on AIMS, being on the periphery, they had the ability to include and exclude certain things. You could be including or excluding components that were part of AIMS. They could select, as they called it, a book of business to use for calculating the amortization. If they did not use the write-back [sic. right book] of business, they would be using a different month than what the production system had and not even realize until they finished the run and then had differences. These were the kinds of things that happened with great regularity even though they had the balances there, but because one could go in and make changes to what was and was not

However, this control was not working effectively. Such a breakdown in controls is clearly evidenced by the size of the adjustment related to the Securities Master Project, and the significant number of securities involved. This issue was known by personnel in the Controller's Department for several years before the problem was resolved.[188]

Prior to the implementation of Security Master, the portfolio area was responsible for the process of coding securities into modeling groups – information that ultimately found its way into the STATS system. This process was essentially a manual process and was not consistently applied by all relevant personnel.[189]

How Factor Anomalies Could Represent Departures from GAAP

As previously described, securities are pooled into similar groups for purposes of modeling. SFAS 91 provides specific guidance on how to determine what constitutes "similar" for the purposes of grouping securities.

Because the Enterprise is the largest holder of mortgage loans and mortgage-related securities, the process of grouping securities into similar groups is a data-intensive process. For example,

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included, certain components, there would be instances where the results would be different because I maintained a tightly controlled system where very few changes could be made, and their system was somewhat different where they in turn were inevitably massaging their write-back [sic. right book] of business, even though you are generating the factors, or some of the factors get passed in error in transition, or they could go through editing, and when the factors come to PDI, and they would show a list showing me their reports and I would reject them and pass them back to them saying there were problems. [...]

[188] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 106-107.

Q: You said earlier that the problem associated with the misclassified securities was something that you yourself became aware of when you started doing this job?

A: Yes.

Q: Who did you report that to in management?

A: We really had – we had a regularly convening FAS 91 kind of group, and that would have been Tom, myself, Leanne, Janet, and over time other people have come and gone, Bill Quinn, et cetera. At the point in time that you're talking about with this conversation, I know there was a conversation with the group at that point in time that this dynamic was going on.

[189] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 98-99.

Q: When did you first become aware that there was going to be a need to reclassify securities that had been erroneously categorized as discounts and reclassify them under premium FAS 91 –

A: When did I first learn that we needed to do that?

Q: Right.

A: It would have been reasonably early on when I took over. When I looked at the inventory of the collateral, you realize that if in the conventional bucket we had premiums and discounts in there. It really became a question more of when could we do something about it because we didn't have the infrastructure at that point in time to do anything about it.

Q: Was it a matter of securities being miscoded as premiums?

A: The process to assign a FAS 91 type before Security Master, the way I understand it, was that the traders would enter a pool type code that would then be translated into a FAS 91 type. So these assignments of pool type code could theoretically be translated from one trader to another trader differently. So there wasn't a way to ensure consistency of application of this information. Once Security Master came in place, we were able to do that by looking at relative sets of attributes and then assigning FAS 91 types at that point in time.

the Enterprise's MBS portfolio alone contains approximately 400,000 different security CUSIPs.[190]

The criteria for determining whether securities can be pooled into a group are prescribed by Question 51 to the Q&A on FAS 91 as follows:

> Q: What characteristics should be considered in determining whether the lender holds a large number of similar loans for purposes of estimating prepayments in accordance with paragraph 19?
>
> A: The objective is to evaluate all characteristics that would affect the ability of the lender to estimate the behavior of a group of loans. The following are examples of some characteristics that should be considered when aggregating loans:
>
> - Loan type
> - Loan size
> - Nature and location of collateral
> - Coupon interest rate
> - Maturity
> - Period of origination
> - Prepayment history of the loans (if seasoned)
> - Level of net fees or costs
> - Prepayment penalties
> - Interest rate type (fixed or variable)
> - Expected prepayment performance in varying interest rate scenarios.

The purpose of the guidance above is to distinguish between loans and/or securities that, based upon their characteristics, should be modeled together because they are likely to have similar estimated lives. Conversely, loans and/or securities that would not be expected to have similar estimated lives should not be modeled together.

From an accounting control perspective, the pooling of securities with dissimilar characteristics would lead to anomalies in the factor array. This could be easily assessed by a comparison of the performance of the underlying collateral to the amount of amortization recorded. As mentioned above, a number of factor anomalies existed which clearly indicated that the guidance in Q&A item 51 was not being followed appropriately.

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[190] OFHEO Interview, Mr. Sam Rajappa, June 17, 2004, pp. 96-97.
Q: What specific parts of the accounting transaction did he not – the accounting for those transactions did he not understand?
A: Okay. Again, I want to make sure – I'm not saying he didn't understand. I'm just saying either he didn't understand or he didn't go there. For whatever reason, he didn't go there.
The way we do the amortization, like we said, we have 400,000-plus securities. It's not possible on each security or a CUSIP to determine what the factors should have been and what it was. So we grouped them into what we considered to be logical buckets of like securities, those with like characteristics. [...]

The Office of Auditing Amortization Investigation

Prior to the commencement of our examination, the Enterprise informed us that Mr. Barnes, a former manager in the Controller's Department, had raised his concerns about several matters including the modeling of amortization factors, significant control deficiencies in the modeling systems, segregation of duties issues as well as other matters.[191]

In August 2003 Fannie Mae's OA performed an Amortization Investigation, which included a review of the controls over factor changes and a review of factor anomalies themselves. The timing of the investigation was made much more complicated due to the fact that the Enterprise's quarterly report on Form 10-Q was expected to be filed the following week.[192] In addition to completing the investigation, Mr. Rajappa also needed to inform the CFO and CEO of the investigation as part of the quarterly financial statement certification process, as well as update the Audit Committee of the Board.

Although some of Mr. Barnes' concerns were raised to the highest levels of the Enterprise, culminating in a presentation by Mr. Sam Rajappa on August 14, 2003 to the Audit Committee of the Board of the Directors, our examination has concluded that the Amortization Investigation was flawed in a number of ways.

Mr. Barnes raised concerns about the modeling process in an e-mail to Sam Rajappa.[193] These concerns were related to three specific anomalies, which he had observed in the data passed to the iPDI system from the AIMS system: 1) factors in excess of 100%, 2) negative factors and 3) factor arrays that amortized almost the entire amount to be amortized in the first few months.[194]

A meeting was held on August 8, 2003, one week after Mr. Barnes expressed his concerns. This meeting was attended by a number of representatives from different internal groups as well as the external auditors to discuss the concerns raised by Mr. Barnes. The OA performed a number of procedures to evaluate the issues raised by Mr. Barnes in preparation for this meeting. At this meeting. Mr. Rajappa stated that "...this process is in compliance with the company's accounting policies that are in compliance with GAAP" and then asked if anyone at the meeting objected to that statement. There were no objections.[195] Although we have interviewed a

[191] Undated document titled 'Unamortized Balances and Factor Analysis', handwritten notes identify Mr. Roger Barnes as the source for this document. FMSE 023356.

[192] The audit notification memorandum is dated August 6, 2003 (FMSE 023289) and the 10-Q was officially filed on August 14, 2003 (http://www.fanniemae.com/ir/sec/index.jhtml?s=SEC+Filings).

[193] An email from Mr. Roger Barnes to Mr. Sam Rajappa, Subject: Request for Meeting, dated July 29, 2003, states that "it is necessary that I schedule an important meeting with you regarding analysis and research I have been conducting for a number of weeks." The email further states "it might be a good idea to invite select members of your staff (Ann Eilers, Paul Jackson, and/or Joyce Philip) who will have familiarity with the subject I must cover." FMSE 024268

[194] "Unamortized Balances and Factor Analysis" Prepared by Mr. Roger Barnes and provided to the Office of Audit. FMSE 023356

[195] OFHEO Interview, Mr. Roger Barnes, September 1, 2004, p. 147-148.
Q: Were you informed that they were concluded or that there was no problem?
A: I think they said it was not material and that it was in compliance with GAAP.
Q: But they never came back and provided you with any supporting documentation at all?

number of witnesses on this particular conclusion, it is still not exactly clear how such a conclusion was reached, since many of the anomalies that Mr. Barnes had identified were subsequently fixed through various projects including the Security Master Project, the enhancements to the Gfee modeling process and the REMIC re-mapping project.[196]

However, one particular test performed by the OA was significant by virtue of the fact that it was performed at all. The OA performed specific procedures to test whether the transactions identified by Mr. Barnes were included in the catch-up analysis. As stated previously, OFHEO strongly disagrees with the Enterprise's accounting (catch-up threshold) for estimation uncertainty. However, if one were to accept the Enterprise's reasoning for establishing a catch-up, would that acceptance further permit including adjustments resulting from data errors and other issues in the catch-up as well? Furthermore, the OA analysis in this regard was flawed for the simple reason that their procedures were insufficient to assess the breadth of the issues or their quantitative impact on the catch-up analysis. Mr. Rajappa's testimony on this matter follows:

> Q: Now, was that correct or appropriate--was it appropriate under generally accepted accounting principles to assign REMICs to FAS 91 buckets regardless of their characteristics?
> A: I do not know the--I cannot opine on the generally accepted accounting principles, but that's the way it was done.
> Q: Were you aware that it resulted in large variance--were you aware that this practice of assigning REMICs to FAS 91 types, regardless of the characteristics of the tranche, that it resulted in large variances in modeling characteristics of the CUSIPs that reside in that type?
> FANNIE MAE LEGAL COUNSEL: Are you reading from a particular part of the document?
> Q: Yes.
> [Pause.]
> A: Yes.
> Q: Yet you had--yet the company concluded overall that its reported results were in accordance with generally accepted accounting principles, correct?
> A: The company concluded--I concluded based on my audit that those specific 62 CUSIPs, give or take a few, and the 26 identified by Jeff, they were part of the beginning balance of the catch-up analysis.
> Q: And that compensating control is what, in fact, made the financial statements correct?

A: No, no one went in depth to try to explain, and that is what led to my comments of how can the review be done when at this point I raised questions and the items in [sic. internal] audit referred to were only one or two of the, so how can you have your review done? We had amortization of – it was occurring so rapidly that we were amortizing the income expense, the entire discount that should have been 10 to 15 years, in as short as seven months. [...]

196 OFHEO Interview, Mr. Jeff Juliane, June 8, 2003, pp. 125-126.
Q: [...] My question is, is it your opinion that the amortization of the securities that he [Mr. Barnes] identified was corrected as a result of implementation of the project?
A: I'll answer that specifically. There was no correction needed in the securities he identified in his analysis. There was an enhancement done through Security Master to better group the assets so these kinds of anomalies from a myopic perspective would not show up any longer.
Q: Do you still have REMIC as 91 categories or REMICs that produce negative factors?
A: A, yes, we do, and – but the occurrence of these are much – have been greatly reduced through Security Master.

FANNIE MAE LEGAL COUNSEL: Would you describe that as- OFHEO has characterized it as a "compensating control." You don't necessarily have to phrase it that way, but...
Q: Would you agree that including that effect in the catch-up is a compensating control?
A: I don't want to quibble on compensating or not, but it is a good control, having a catch-up analysis that is approved by our external auditors and making sure that the catch-up analysis starting point included this and all the other effects that we talked about that could change. As a starting point, I think that is a good--that gave me comfort.[197]

The Office of Auditing's attention was also brought to another matter related to a manual factor change submitted by the modeling group. This matter was raised at the August 8, 2003 meeting to address the issues raised by Mr. Barnes.[198]

The iPDI system, which at that point was the responsibility of Mr. Barnes, had the capability to manually change an individual factor that had previously been passed from AIMS. A manual change could be necessary if, for instance, it became too late in the closing process to effect another complete pass of information from AIMS to iPDI. If a change was necessary, a message would be sent from the AIMS modeling team to the iPDI team to process the change. In addition, the AIMS team was responsible for validating the reason for the change. This is a segregation of duties that no longer exists today as a result of the changes to Mr. Juliane's responsibilities.

The manual factor change was processed "without full understanding by the iPDI group of the reason for the change"[199] and despite the fact that "written documentation supporting the change request was not sufficient."[200] The minutes of the August 8, 2003 meeting clearly state Mr. Barnes' concern: "Roger said that this transaction bothered him because it appeared that the factor change was made to make iPDI "agree" with forecasted amortization expense."[201] Mr. Barnes' concerns were significant because, in his mind an intentional misstatement may have occurred, and by raising his concerns, he also brought attention to the potential segregation of duties issue in the Controller's Department.

The CFO, Mr. Howard, clearly understood that Mr. Barnes had alleged an intentional misstatement in the matter of the $6.5 million factor change. When OFHEO asked Mr. Howard whether Mr. Barnes had made such an allegation, Mr. Howard responded as follows: "Well, he alleged that was intentional misstatement."[202] Ms. Spencer, who reported directly to Mr. Howard and was ultimately responsible for the amortization area because it was part of the

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[197] OFHEO Interview, Mr. Sam Rajappa, June 17, 2004, pp. 99-101
[198] Summarized Minutes of the Meeting (8/8/03), Unamortized Balances and Factor Analysis, FMSE-SP 000081. The minutes state that "Roger [Barnes] said that this transaction bothered him because it appeared that the factor change was made to make iPDI "agree" with forecasted amortization expense."
[199] *Id.*, The meeting concluded the investigation by the Office of Auditing and was attended by members of the Controller's Department, Financial Standards, Office of Auditing, Corporate Compliance and KPMG.
[200] Fannie Mae Office of Auditing, Amortization Investigation, August 2003, FMSE 023283
[201] Summarized Minutes of the Meeting (8/8/03), Unamortized Balances and Factor Analysis, FMSE-SP 000081.
[202] OFHEO Interview, Tim Howard, August 5, 2004, p. 99.

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Controller's Department, did not understand Mr. Barnes' allegation as intentional misstatement or fraud.[203]

In addition, neither Mr. Rajappa, nor his staff (the very people who were responsible for conducting an independent investigation) understood his allegations as intentional misstatement. [204] Such a lack of understanding is strange, especially since the summarized minutes of the August 8, 2003 meeting (which included the statement made by Mr. Barnes that the factor change appeared to have been made to make actual results *agree* with forecasted results) were prepared by Mr. Paul Jackson, Director in the OA, and were reviewed by Mr. Rajappa.[205]

What made the manual factor change even more difficult to understand is the way in which it was processed. It seems, according to documentation reviewed by OFHEO, that the issue that gave rise to the need for the factor change occurred in one particular FAS 91 type but the factor adjustment actually occurred in a different FAS 91 type.

The factor change actually occurred in the FAS 91 type RMC T802. RMC T802 is a special FAS 91 type, which was created for a particular pool of securities related to a single transaction. The RMC T802 bucket was chosen because it would be easier to deal with later operationally when

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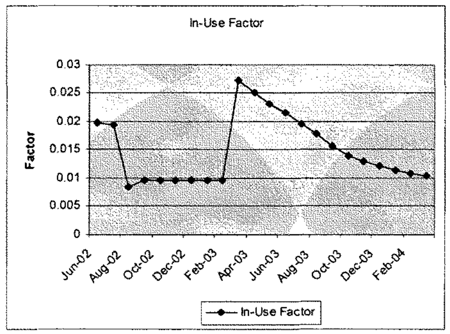
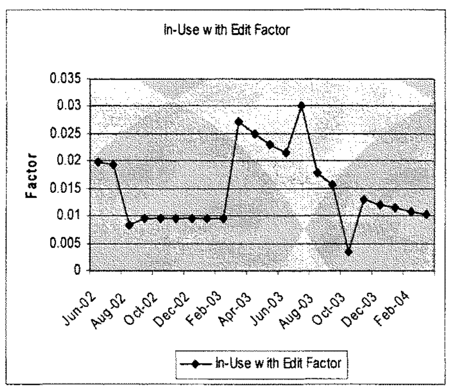
[203] OFHEO Interview, Leanne Spencer, August 12, 2004, pp. 52-53.
Q: Okay. At any time in the past, did you ever have the opinion that the company's accounting was not in accordance with generally accepted accounting principles?
A: No.
Q: Are you aware of any company officer or employee ever expressing their belief that any of Fannie Mae's accounting policies or practices were inconsistent with GAAP?
A: There was an employee in the controller's department in 2003 that raised some concerns to the level of the controller of some items that he felt warranted looking into and was unclear if they were appropriate and we investigated it.
Q: And that was Roger Barnes?
A: That's correct.
Q: When he raised these issues, did he ever allege fraud or intention to misstate financial results?
A: No. Not to me.
Q: Okay. Did you ever develop an awareness that that was what he was alleging?
A: No. I -- no.
[204] OFHEO Interview, Ms. Ann Eilers, July 23, 2004, p. 222
Q: Now you testified earlier that you were present in the initial meeting that Roger Barnes had with Sam Rajappa where Mr. Barnes provided his concerns regarding premium discount amortization; correct?
A: Yes.
Q: Now did Mr. Barnes make any allegations or statements regarding intentional misstatements?
A: At that meeting?
Q: Yes.
A: Not that I recall.
Q: Did he make any allegations or assertions regarding intentional misstatements at any other time that you are aware of?
A: Not that I'm aware of.
[205] OFHEO Interview, Mr. Sam Rajappa, June 17, 2004, p. 86-87.
Q: Did you prepare this document (FMSE-SP 000080-81)?
A: No, I reviewed it. I believe it was prepared by Mr. Paul Jackson.

the factor change (which was made in iPDI) would need to be reflected in the data which feeds the AIMS system (from ALEX).[206]

OFHEO has prepared graphs to show the before and after effects of the factor change:



The chart above is as of July 31, 2003 and, as such, shows the actual factors used prior to July 2003 and the projected factors for periods thereafter. The prospective factor array (after June 30th) is –as would be expected- a curvilinear, downward sloping line.



[206] "However, FAS 91 type RMC-T802 was selected for the factor change simply because it had only one underlying security (thus no changes would be required at the next discrete level – ALEX product type.)" KPMG 2003 workpapers "FAS 91 Amortization – Manual Adjustments", KPMG 000904.

The chart above shows the effect that the factor change has on the prospective array (after June 30th). Because the factor array should correlate roughly to the forecasted cash flows (in this case on a security) the prospective factor array created by the factor change is clearly not logical.

The factor change was applied to two specific factors in the array for one amortization type for the periods of July and October 2003. This resulted in a transfer of amortization expense of approximately $ 6.5 million from future periods to the 3rd quarter of 2003. According to testimony provided by Mr. Juliane during OFHEO's examination, the business purpose of the factor change adjustment was to roll forward the book of business used for modeling purposes.[207] However, the rate change clearly seems to be counterintuitive based on the revised array of factors. The end result of the change (as the charts show) was to shift income from the July 2003 period into future periods.

Fannie Mae's OA reviewed the documentation supporting the request for the factor change as part of the Amortization Investigation performed in August 2003 and concluded that the supporting documentation was in fact not sufficient to support the factor change made.[208]

Based on the information the OA team received from the modeling group during their investigation the OA team was not able to come to a conclusion about whether the factor change causing the $ 6.5 million adjustment to amortization income was in fact a *valid adjustment*. The procedures performed by the OA team consisted of reviewing the supporting documentation provided by the modeling group and, despite several requests, conclusive documentation was not provided by the modeling group. It was at precisely that point that the OA concluded its investigation. **The lack of diligence on behalf of the OA in the matter of the manual factor change is inconsistent with their responsibility to exercise due professional care.**

The summarized minutes of the meeting on August 8, 2003 include the following conclusion from Mr. Rajappa:

> Sam [Mr. Rajappa] stated that in his opinion, the July factor change process showed a weakening of this control because the factor change request did not include sufficient written documentation to support the transaction and because a change was made without full understanding by the iPDI group of the reason for the change. Sam added that this required remediation in the form of written

[207] OFHEO Interview, Mr. Jeff Juliane, June 8, 2004, pp. 117-118
Q: Do you recall the $ 6.5 million factor change and what it related to?
A: Yes.
Q: Can you describe it?
A: [...] what we did is that we did a factor change. And in AIMS we had done an estimate on what that factor change was. There were new business books that we took into consideration. We basically rolled for our estimate and came up with an estimate that was. $6.5 million higher than what iPDI was booking. So, I vetted that conversation with my management team, and we decided that, based on my analysis, that we would increase the expense by $6.5 million through and a partial factor change.

[208] Summarized Minutes of the Meeting (8/8/03). Unamortized Balances and Factor Analysis, FMSE-SP 000081

procedures and better defined roles and responsibilities. Jonathan Boyles agreed with this statement.[209]

When asked during his testimony whether, in the instance of an assertion regarding intentional misstatements, it would be the Enterprise's policy to prove that entries made to the financial statements are in fact correct, Tim Howard, Chief Financial Officer, testified that it would be expected practice to verify the validity of these entries.[210] However, Fannie Mae's OA did not perform additional auditing procedures to determine if the request for a factor change was valid or not. In fact management of Fannie Mae's OA "had no basis to believe it was correct or wrong"[211] and could "not rule out the possibility that entry could be incorrect."[212]

Therefore the amortization investigation performed by Fannie Mae's OA did not arrive at a conclusion on whether or not these factor changes are made to manage earnings rather than to arrive at a best estimate for the amortization period of the underlying securities.

Lack of Written Procedures and Supporting Documentation, and an Insufficient Audit Trail

In July 2003 Fannie Mae's Office of Auditing issued its Audit Report[213] summarizing the results of their review of controls over Fannie Mae's amortization of mortgage related price adjustments. OFHEO believes that this report was flawed because it merely reflected a "yellow" rating of "controls need strengthening requires attention during normal course of business," rather than a "red" rating of "Controls need strengthening, request immediate attention." OFHEO further believes that the characterization of findings within the report was either not clear, did not provide appropriate emphasis and inappropriately represented certain significant control weaknesses as documentation issues. Lastly, OFHEO determined that a number of meaningful findings that were noted in the workpapers were inappropriately omitted from the report.

However, irrespective of OFHEO's evaluation of the July 2003 OA report itself, matters noted by OA auditors, in combination with OFHEO's own analysis and findings **suggest a pervasive lack of written procedures and documentation for most of the Enterprise's amortization activities.**

OFHEO has concluded from its own examination procedures that:

- Insufficient documentation existed for most procedures.

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[209] Summarized Minutes of the Meeting (8/8/03), Unamortized Balances and Factor Analysis, FMSE-SP 000080-000081

[210] OFHEO Interview, Mr. Tim Howard, Chief Financial Officer, August 5, 2005, p. 58

Q: In the instance of an assertion regarding intentional misstatement, would it be company policy to prove that any entries made to the financial statements were in fact correct?

FANNIE MAE LEGAL COUNSEL: Are you talking specifically about the Barnes complaint or generally?

Q: Generally.

A: I don't know that I would say company policy. It would certainly be expected practice to do so.

[211] OFHEO Interview, Mr. Sam Rajappa, June 17, 2004, p. 108

[212] OFHEO Interview, Mr. Paul Jackson, August 17, 2004, pp. 152-153

[213] Fannie Mae Audit Report, Office of Auditing, Amortization Audit, July 9, 2003, FMSE 023745-023754.

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- Explanations regarding the basis for changes to methodology were not adequate or appropriately documented.

- Catch-up results were poorly documented, particularly for the periods prior to 2003.

- Inconsistent accounting methods were applied without adequate supporting explanation.

- Factor change adjustments were not sufficiently explained or documented.

In addition, an observation contained within the July 9, 2003 report was that "policies over data processes and key modeling methodology and assumptions should be developed to provide better supportability."[214] Specifically, the audit report pointed out that "procedures do not specify what level of documentation is required to support actions taken, or what level of management involvement is required."[215] Additional areas, not stated previously, cited for lacking appropriate documentation included among others:

- Modeling performed outside the AIMS framework
- Use of proxies instead of actual data

Other items *not* included in the audit report, but separately conveyed to business unit management further identified the need to develop guidelines to address documentation requirements related to:

- The use of proxies for FAS 91 types used to group types of securities with similar characteristics;
- Manual factor adjustments to the amortization accounting sub-ledger and
- Archiving the support for interest rate assumptions and the level of required management approval of these interest rate assumptions.[216]

Lastly, the workpapers prepared by Fannie Mae's Office of Auditing include comments about formalizing and documenting procedures to properly address the modeling process including changes to the modeling methodology and to CPRs[217] used in the modeling process.[218]

In evaluating the catch-up process, Fannie Mae's Office of Auditing identified several further areas with documentation weaknesses as described below:

- Approval procedures documented in 2001, may not still apply and are not being followed currently. Specifically, Portfolio Management does not sign off on the Sensitivity Analysis prepared by the Controller's Department

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[214] *Id.*, FMSE 023749
[215] *Id.*, FMSE 023749
[216] Email from Ms. Joyce Philip, Manager Office of Auditing, to Mr. Jeff Juliane and Mr. Paul Jackson, Director Office of Auditing, July 6, 2003, FMSE 118812
[217] CPR stands for Constant Prepayment Rate and is one of the critical components used in determining amortization factors.
[218] Fannie Mae Office of Auditing SDI, Amortization Audit 2003, FMSE 117502-117503, states that "there are not documented procedures that address the CPR change process and specifically the documentation and approval process."

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- Documented procedures do not address the incorporation of current month acquisitions activities into the quarterly catch up analysis and adjustment process. Adjusting the catch up analysis to include current period acquisitions was first incorporated in November 2002 for the September book of business.[219]

- The business analyst who runs the AIMS model was unable to provide support for the current acquisitions adjustments – this could only be provided by the manager – potential Key Person Dependency.

- There are no guidelines that identify what activities require management [approval or sign-off]."[220]

OFHEO believes that the lack of documented procedures and underdeveloped audit trail for the various processes and systems used to calculate deferred price adjustment amortization allowed personnel within the Enterprise to affect the management of earnings and volatility in a manner not easily observable or readily subject to sufficient review.

[219] Note that the process of determining the impact of current acquisitions on the catch-up analysis is performed manually.
OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 60-61
Q: And you said that's done manually, so what systems in particular is that information –
A: Well, we don't do it manually. It's done through system interfaces between us and ALEX. There's no manual processing involved at all in terms of rolling the book forward. We manually [sic. model] outside the system, if we're on a December book of business, look at the catch-up impact of January acquisitions and February acquisitions. That's the manual process in terms of generating the sensitivity that I'm talking about. [...]

[220] Fannie Mae Office of Auditing Workpaper, Amortization Audit 2003, FMSE 118804-118807 The workpapers prepared by Fannie Mae's Office of Auditing cut off the text in the last bullet point. However, the related SDI prepared by the Office of Auditing titled "Catch Up Processes and Controls are not fully articulated, formalized, or documented" states that "the following areas need to be better defined" listing among others "when management approval/sign-off is required." FMSE 118808

HEDGE ACCOUNTING UNDER SFAS 133

Introduction

OFHEO's on-going special examination has placed a specific focus on Fannie Mae's application of Statement of Financial Accounting Standards No. 133 *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"). SFAS 133, which was issued in 1998 and became effective in 2001, presented Fannie Mae with the potential for significant volatility in earnings and several operational challenges. For the Enterprise to avoid much of the potential earnings volatility caused by marking derivatives to fair value under SFAS 133, it elected to adopt hedge accounting under the new standard. However, qualifying for hedge accounting under SFAS 133 required changes to significant administrative, documentation, and system requirements for most entities. For an entity with a large and dynamic hedging program, like Fannie Mae, hedge accounting posed even greater challenges. Fannie Mae devised a hedge accounting approach in which the vast majority of its derivatives were treated as "perfectly effective"[221] hedges with the objectives of minimizing earnings volatility and simplifying operations. OFHEO has determined that Fannie Mae has misapplied GAAP (specifically, the hedge accounting requirements of SFAS 133) in pursuit of these objectives. The misapplications of GAAP are not limited occurrences, but appear to be pervasive and reinforced by management whose objective is to reduce earnings volatility at significant cost to employee and management integrity. The matters discussed herein raise serious doubts as to the validity of previously reported financial results, as well as adequacy of regulatory capital, management supervision, and overall safety and soundness of the Enterprise.

Background

SFAS 133,[222] as amended and interpreted, provides the primary guidance under GAAP for companies' accounting and reporting for derivatives. The accounting framework in SFAS 133 brought significant changes to prior accounting practice and effectively superseded concepts such as synthetic accounting.[223] SFAS 133 requires that all freestanding and certain embedded derivatives be carried on the balance sheet at fair value. Changes in a derivative's fair value are included in earnings, unless the derivative is ***designated and qualifies*** for hedge accounting. Hedge accounting provides a means for a matching of the earnings effect of a derivative and the related designated hedged transaction, thereby mitigating the impact of marking-to-market the derivative under SFAS 133.

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[221] See discussion of "perfectly effective" hedge relationships in; The Assumption of Perfect Effectiveness, herein.

[222] Appendix II provides a summary of the basic provisions of SFAS 133.

[223] Synthetic accounting was the accounting treatment followed by many entities, including Fannie Mae, prior to SFAS 133. Paragraph 349 of SFAS 133 defines synthetic instrument accounting as follows: "Synthetic instrument accounting, which evolved in practice, views two or more distinct financial instruments (generally a cash instrument and a derivative instrument) as having synthetically created another single cash instrument. The objective of synthetic instrument accounting is to present those multiple instruments in the financial statements as if they were the single instrument that the entity sought to create."

Synthetic instrument accounting essentially allowed derivatives to be accounted for on an accrual basis together with the related hedged item, in order to "synthetically" replicate a fixed or floating rate instrument, as applicable.

Hedge accounting is elective. However, to qualify, certain stringent criteria must be satisfied. These requirements were outlined in a recent Securities and Exchange Commission ("SEC") speech by John James, Professional Accounting Fellow from the Office of the Chief Accountant at the SEC. Below is an extract from the speech which emphasizes the strict criteria necessary to receive hedge accounting:

> Many have complained that Statement 133 is not a principles-based standard and that its rules are too complex to follow. However, the principle in Statement 133 is fairly straightforward in that derivatives should be recorded on the balance sheet at fair value with changes in fair value reported in earnings. The complexity is mostly associated with achieving hedge accounting, which is optional under Statement 133. Thus, in order to achieve hedge accounting, the Board concluded that entities would be required to meet certain requirements at the inception of the hedging relationship and on an ongoing basis. These requirements include: contemporaneous designation and documentation of the hedging relationship, the entity's risk management objective and strategy for undertaking the hedge - including, identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how effectiveness will be assessed and measured. Additionally, Statement 133 requires an entity to perform a hedge effectiveness assessment at both the inception of the hedge and on an ongoing basis as support for the assertion that the hedging relationship is expected to be (or was) highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the designated hedging period.
>
> Those are the requirements. They were pretty well understood in and around the adoption date of Statement 133; however, as commonly happens as a standard matures, the staff has recently observed situations of "sloppy" documentation and aggressive interpretations of Statement 133's hedge accounting guidance. [224]

Implementation of SFAS 133 at Fannie Mae

Prior to SFAS 133, Fannie Mae followed synthetic instrument accounting for debt instruments whereby cash flows were synthetically altered through the use of derivatives. As Fannie Mae was not a "mark-to-market" entity, the new accounting for derivatives under SFAS 133 would significantly affect the volatility of its financial results if hedge accounting were not applied. Some entities, such as broker-dealers and investment companies, account for most of or all of their assets and liabilities at fair value, with changes therein flowing through earnings (referred to as "mark-to-market" accounting). When such entities use derivatives to manage risk, they often achieve a natural offset in earnings due to the mark-to-market of both the derivatives and the assets/liabilities that give rise to the risk. Fannie Mae, as well as most banks and finance companies, apply a modified historical cost approach to accounting for most financial assets and

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[224] Extract from John James, Professional Accounting Fellow from the Office of the Chief Accountant - US SEC, speech at the 2003 Thirty-First American Institute of Certified Public Accountants ("AICPA") National Conference on Current SEC Developments held in December 2003.

liabilities. Thus, the introduction of fair value accounting for derivatives under SFAS 133 had the potential to create significant earnings volatility unless hedge accounting was used to allow an offset to the earnings effect of marking the derivatives to market.

Fannie Mae faced significant challenges in qualifying for hedge accounting. Due to its extensive documentation and effectiveness calculation requirements, hedge accounting under SFAS 133 was most easily adopted by entities with simple, passive hedging approaches in which hedges are established and allowed to run their course. However, Fannie Mae's hedging approach was neither simple nor passive. The complex nature of funding its massive mortgage portfolio and managing the associated interest rate risk necessitated an active, dynamic hedging approach to respond to changing market conditions and portfolio re-balancing requirements. Such an environment adds significant complexity to the administrative and systems requirements to support hedge accounting. Furthermore, Fannie Mae's use of option-based derivative products further complicated the application of hedge accounting, due to additional complexities associated with such instruments.

Determination to maintain the pre-SFAS 133 accounting

Despite the challenges noted above, Fannie Mae had a strong desire to retain the status quo of accrual/synthetic instrument accounting. Fannie Mae's net interest margin reflects the spread between the income earned on its assets (interest income) and its cost of funding (interest expense). Synthetic instrument accounting provided relatively smoother accounting earnings and greater predictability of reported financial results, including Earnings Per Share ("EPS"). Fannie Mae's derivatives accounting policy makes several references to derivative transactions in which the intended result is for the accounting to continue to mimic synthetic instrument accounting even after the adoption of SFAS 133.

Minimizing Earnings Volatility a Primary Objective

Fannie Mae documents relating to its SFAS 133 implementation discuss minimizing earnings volatility and maintaining the simplicity of the Enterprise's operations as the primary objectives when Fannie Mae undertook the implementation of the standard. [225] Earnings volatility would naturally arise from those derivatives that did not qualify for hedge accounting and from any hedge ineffectiveness resulting from hedging relationships that qualified for hedge accounting. OFHEO acknowledges that minimizing earnings volatility and simplifying operations in connection with the adoption of SFAS 133 are not prohibited and that many companies likely had similar objectives in their implementation of the standard. However, as discussed further below, these goals have influenced the development of misapplications of hedge accounting.

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[225] Memorandum from Jonathan Boyles, Senior Vice President–Financial Standards and Corporate Tax Compliance, to Distribution, Subject: Background on SFAS 133 implementation, March 2, 2003, FMSE 078540 – 078542, in which Mr. Boyles stated that, "At the time of our implementation efforts there were several tenets that we [sic] drove our decisions regarding implementation and derivatives strategies. In the simplest terms, these tenets were: 1. Earnings volatility was to be minimized and if there were earnings volatility it should be as predictable as possible. 2. We were to leverage off existing systems as much as possible, 3. Operating earnings needed to be simple and easily understood."; and presentation document, "Examining Our Hedging Strategies-Post FAS 133," Tim Howard, Peter Niculescu, Linda Knight, Leanne Spencer, David Benson, Jonathan Boyles, Bill Quinn and Mary Lewers, May 9, 2003, FMSE 027242-027265, bullet three on page 2 of the presentation (FMSE 027243) states, "Goals when we adopted FAS 133: minimizing earnings volatility, leverage existing systems, keep operating earnings simple..."

These improper approaches included not assessing hedge effectiveness, not measuring hedge ineffectiveness when required, and applying hedge accounting to hedging relationships that do not qualify for such treatment.

Derivatives Accounting Policies & Procedures
Fannie Mae's accounting policies for derivatives post SFAS 133 are contained in the Derivatives Accounting Guidelines ("DAG"). The DAG represents Fannie Mae's effort to detail the potential derivative transactions that the Enterprise may enter into, the accounting to be followed for such transactions, and the impact the accounting has on earnings. The DAG serves as the foundation for Fannie Mae's derivative accounting. Interviews with Fannie Mae personnel indicate that these guidelines also formed the basis for system development efforts to support SFAS 133.

The DAG has the appearance of a comprehensive set of accounting policies. However, a close review of the guidelines revealed numerous instances of departures from hedge accounting requirements under SFAS 133. Jonathan Boyles, Senior Vice President – Financial Standards & Corporate Tax, is the head of accounting policy formulation at Fannie Mae, and had primary responsibility for the DAG's development. Mr. Boyles has referred to some of these matters as "known departures from GAAP".[226] Other members of Fannie Mae management refer to these matters as "practical applications" of GAAP.[227] These departures, or practical applications, had the effect of allowing Fannie Mae to apply hedge accounting and the assumption of perfect effectiveness[228] to numerous transactions in situations where such treatment was not appropriate without the necessary documentation and analysis.

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[226] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Accounting Standards and Corporate Tax, August 3, 2004, p. 64. In the interview, Mr. Boyles stated, "We have several known departures from GAAP in our adoption of FAS 133. We have cleared those with our auditors. We have reported to our auditors on an annual basis the effect of those. And they were comfortable when we adopted them, and they were comfortable over the last several years when we reported the results of that work."

[227] OFHEO Interview, Leanne Spencer, Controller, August 12, 2004, pp. 28-29. In the interview, Ms. Spencer made reference to a "practical application" of GAAP:

Q: Did KPMG ever request that you perform some ongoing measurement in order to determine whether a materiality threshold had been exceeded?

A: We have had had [sic], over the course of time, we have had had [sic] situations where we've looked at GAAP, we've said, how do you take this technical literature and how do you apply it to how Fannie Mae's business runs, and made a judgment, not Fannie Mae making a lone judgment, but in working with our external auditors and their concurrence that what I recall my words are practical application, how you take a technical piece of literature, and you try to overlay it into how a company does business and that we have periodically have several areas where you do back-testing.

[228] OFHEO Interview, Mary Lewers, Vice President—Financial Accounting, July 13, 2004, p. 132. In the interview, Ms. Lewers confirmed that perfectly effective hedges are those for which there is no explicit assessment or measurement of effectiveness.

Q: So, if you don't qualify for perfect effectiveness, you would use the long haul method.

A: Uh-huh.

Q: And does the long haul method include both assessment and measurement of effectiveness?

A: Yes, it does.

Q: So that would mean that for the perfectly effective hedges, there's no explicit assessment or measurement of effectiveness; is that correct?

A: That's a correct statement.

The Assumption of Perfect Effectiveness

Consistent with Fannie Mae's desire to minimize earnings volatility and maintain simplicity of operations, a great deal of emphasis was placed on treating hedges as perfectly effective, whereby it is assumed that no ineffectiveness exists in a hedging relationship, and no assessment or measurement of effectiveness is performed. [229] In fact, Fannie Mae treats almost all of its hedging relationships as perfectly effective. [230] SFAS 133 does allow the assumption of no ineffectiveness, but only in very limited circumstances. However, in many instances, as discussed further below, Fannie Mae has disregarded the requirements of SFAS in its treatment of hedges as being perfectly effective. Accordingly, the Enterprise has not properly assessed and measured effectiveness as required by the standard. At December 31, 2003, Fannie Mae had a notional of $1.04 trillion in derivatives, of which a notional of only $43 million was not in hedging relationships.[231]

The importance given by management to an assumption of perfect effectiveness in hedging relationships is further highlighted by the fact that Fannie Mae's accounting policy required special management approval for derivatives requiring "long haul"[232] treatment. However,

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[229] OFHEO Interview, Janet Pennewell, Senior Vice President—Financial Reporting and Planning, June 15, 2004, p.197

Q: Do you believe or is it your understanding that an emphasis is placed by Fannie Mae on structuring their hedge strategies to attempt to achieve the "perfect hedge" or no ineffectiveness?

A: I believe that that was consistent with our objective early on. In fact, I believe that leading into the implementation of FAS 133 that we looked at the different derivatives that we were using with an objective of trying to use those derivatives and those hedging vehicles that we thought we could assume were perfectly effective. But I think it's not always the case.

[230] OFHEO interview, Jonathan Boyles, Senior Vice President of Accounting Standards and Corporate Tax, August 3, 2004, p. 45, in which Mr. Boyles stated that he would guess over 90% of Fannie Mae's hedges are perfectly effective at any point in time.

Q: That's what I'm talking about. In terms of what is actually on the books, not in terms of the transactions described in the policy, but what's on your books today or at any point in time. Generally how much of the portfolio would be treated as perfectly effective?

A: I would guess over 90 percent, but I don't see those reports.

OFHEO interview, Mona Patel, Senior Project Manager—Financial Accounting Group, September 8, 2004, pp. 118-119

Q: What percentage of your--of the derivatives portfolio would you say qualified for perfect effectiveness?

[...]

Q: Any estimates that you may have?

A: [...]The majority of our linkages get perfectly effective hedge accounting except for a couple of long hauls or [sic] the population. So, anything that other [sic] long haul is all perfectly effective accounting.[...]

Q: And we are not trying to get a precise, but--precise number but just an approximation. Is it five? Is it a hundred? Is it two? I mean, just roughly, how many long-haul calculations tend to be performed on a given month?

A: Not a given month. There was none, like in one in April. If there are any, they're a handful.

[231] Fannie Mae December 31, 2003 10-K, Table 30 "Notional and Fair Value of Derivatives by Hedge Designation," p. 79. These balances exclude mortgage commitments accounted for as derivatives under SFAS 149. Note that the $43 million which were not in hedging relationships represent approximately 0.004% of the total $1.04 trillion notional amount of outstanding derivatives.

[232] OFHEO Interview, Mary Lewers, Vice President—Financial Accounting, July 13, 2004, p. 132. Fannie Mae designates hedge relationships in which it cannot assume perfect effectiveness. In these situations, SFAS 133 requires that Fannie Mae assess effectiveness and measure ineffectiveness to qualify for

Fannie Mae requires no such special approval for hedges treated as perfectly effective -- thereby making perfect effectiveness the rule, and long haul treatment the exception. As noted above, there are specific requirements that must be met under SFAS 133 to treat hedges as perfectly effective. The complex nature of Fannie Mae's hedging approach makes meeting these requirements difficult. OFHEO believes that Fannie Mae did not place sufficient emphasis on policies, procedures and approval requirements to ensure that the proper accounting treatment was applied. Instead, their procedures focused on special review and approval of transactions that might cause earnings volatility or operational complexity.

Hedges that do not meet the criteria for being perfectly effective require an assessment of effectiveness that must be performed to qualify for hedge accounting. As noted above, OFHEO's analysis indicates that Fannie Mae has many hedging relationships that do not qualify as perfectly effective, yet have been treated as such. Since Fannie Mae has not performed a proper assessment of hedge effectiveness for such transactions, these transactions do not qualify for the hedge accounting treatment that they have been given. Instead, the proper accounting for such derivatives would be for their fair value changes to be recorded directly through earnings. OFHEO believes that the disqualification of hedge accounting for such a large number of transactions would have a significant impact on Fannie Mae's reported financial results, both prospectively and historically.

Environment for Formulation of Derivatives Accounting Policy at Fannie Mae

There are a number of issues that are important to understand as it relates to the environment in which Fannie Mae's derivatives accounting policies and practices were developed:

> **Financial Standards Group: Significant Reliance on Limited Resources** – The Enterprise relies heavily on its Financial Standards Group for advice on the application of accounting policy. There does not appear to be an environment conducive to questioning or challenging accounting decisions made by the Financial Standards Group. Fannie Mae's Office of Auditing also relies on the Financial Standards Group to formulate accounting policy for the Enterprise in accordance with GAAP. Although the Office of Auditing reports conclude that Fannie Mae's accounting for derivatives is in compliance with SFAS 133, the Vice President of Office of Auditing (A. Eilers) indicated in her testimony that the Office of Auditing verifies compliance with Fannie Mae policy as it is

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hedge accounting. This is commonly referred to as the long haul approach. Ms. Lewers confirmed this definition in her testimony.
Q: [...]Are you familiar with the terminology that's used in the Derivative Accounting Guidelines known as the long haul method?
A: Yes, I am.
Q: And is the long haul method the method that is used for hedges that are not perfectly effective?
A: Yes. Long haul would be used in a situation in lieu of perfect effectiveness, if we didn't qualify for perfect effectiveness. [...]
Q: And does the long haul method include both assessment and measurement of effectiveness?
A: Yes, it does.

established by the Financial Standards Group, and does not check for the policy's compliance with GAAP. [233]

Despite the significant influence wielded by the Financial Standards Group, it is comprised of relatively few personnel.[234] OFHEO believes the limited resources devoted to complex technical accounting matters has contributed to Fannie Mae's problems with SFAS 133 compliance.

Lack of Adequate Understanding by Accounting Operations –Accounting and treasury operations personnel that are responsible for the implementation of certain aspects of the standard lack an adequate understanding of SFAS 133. This lack of understanding is attributed to the groups' significant reliance placed on the Financial Standards Group. Testimony from various members of the Controller's organization and the Controller indicated that questions relating to the accounting for derivatives could only be answered by the Senior Vice President of the Financial Standards Group (J. Boyles). [235] OFHEO noted that individuals having responsibility for key aspects of the SFAS 133 accounting process (such as ensuring hedge designation occurs, or checking to ensure matching of critical terms) were not knowledgeable about how such activities met the requirements as set forth under GAAP. [236]

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[233] Audit Report, Subject: Derivatives Controls Audit, March 31, 2003, FMSE 102385-102391. The audit report conclusion states, "Controls are in place to capture derivative transactions, monitor counterparty risk, monitor FAS 133 compliance, and report accurate financial results."
Audit Memorandum from Joyce Phillip, Director of Office of Auditing, to Leanne Spencer, Subject: New Accounting Standards Review, February 17, 2004. This memorandum was provided by OFHEO staff and was not provided through the Fannie Mae Special Examination Production; therefore, no Bates number is available. The memorandum's conclusion states, "Fannie Mae's implementation of FAS 149, FIN 45 and FIN 46 is consistent with FASB requirements."
The conclusions reached in the two documents referenced above state that the Office of Auditing has verified compliance with GAAP. However, these conclusions are not consistent with Ann Eilers' testimony.
OFHEO interview, Ann Eilers, Vice President -- Office of Auditing, July 23, 2004, p. 29, where she stated, "As far as GAAP accounting, that's really the role of Financial Standards who runs -- you know, has a team of professionals who basically review GAAP accounting rules, and they would then work with KPMG. At the end of the day KPMG ultimately opines on GAAP. Internal audit would not do that. We basically opine on the controls around those processes."

[234] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Standards and Corporate Tax, August 3, 2004, p. 10
Q: When Greg Ramsey came in, did the size of the group grow in terms of the people reporting to him, or when did you get from the four to the eight? I'm just trying to get a sense of timing.
A: Going from the four to the eight has been within the last 18 months.

[235] OFHEO interview, Mary Lewers, Vice President – Financial Accounting, July 13, 2004, p. 45, in which she stated, "Accounting Standards is what I would refer to as our expert advice regarding the translation of GAAP into appropriate policy....So I would define myself as someone who was learning this, but that the real sort of expert advance (sic) in terms of how to translate this into compliance with GAAP, it really rested within the Financial Standards team."

[236] OFHEO interview, Katarina Skladony, Senior Financial Analyst – Treasury Middle Office, August 26, 2004, pp. 144-146, in which she stated, among other things, that the Financial Standards Group did not make her aware of the requirements of SFAS 133.
Q: Ms. Skladony, are you aware that for getting hedge accounting, you have to have contemporaneous documentation?

Disregard of FASB Decisions – Like many entities, Fannie Mae engages in active efforts to influence the Financial Accounting Standards Board's ("FASB") rule making decisions, with a goal of advancing the accounting positions it views as most favorable to the Enterprise. SFAS 133 was no exception in this regard – according to documents obtained by OFHEO, Fannie Mae played an active role in lobbying the FASB both prior to the issuance of the standard and subsequently. In some instances, despite entreaties to the FASB by Fannie Mae for a desired derivative accounting treatment, the FASB rejected the requested treatment. At times, even though the FASB had rejected the requested treatment, Fannie Mae disregarded the FASB's guidance and accounted for their transactions the way they had originally proposed. This sheds some light on the culture and attitude within Fannie Mae – a determination to do things "their way."

One such instance relates to certain illustrative transactions included in SFAS 133's Implementation Guidance that were apparently initiated and drafted by the SVP of the Financial Standards Group (J. Boyles). These illustrative transactions addressed accounting for both "termouts"[237] and "offsetting swaps" discussed in this report. OFHEO understands the approach as originally proposed by Fannie Mae would have resulted in treatment of these transactions as perfectly effective hedges. The FASB ultimately rejected this treatment in the guidance ultimately published in SFAS 133. However, Fannie Mae disregarded this guidance and accounted for these types of transactions the way they had originally advocated.[238]

FANNIE MAE LEGAL COUNSEL: With respect to FAS 133?
Q: Right.
A: I'm not familiar with FAS 133 requirements.
Q: Are you aware that you have to produce documentation at the time the trade is contemplated?
FANNIE MAE LEGAL COUNSEL: You say again "you." I'm just—
Q: You meaning she.
FANNIE MAE LEGAL COUNSEL: Do you understand that's a requirement of FAS 133? That's your question?
Q: Yeah.
FANNIE MAE LEGAL COUNSEL: Okay.
A: No. [...]
Q: So you were not made aware by Financial Standards that contemporaneous documentation is required; is that correct?
A: That's correct.

[237] OFHEO understands the word "term-out" to be used by Fannie Mae generally to describe the replacement of discount notes with fixed rate notes or different floating rate borrowings.

[238] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Standards and Corporate Tax, August 3, 2004, pp. 177-178. OFHEO notes that this particular example is Example 8 in paragraphs 153-161 of SFAS 133
Q: Was that the Example 8 in the appendix—
A: It was the Fed Funds' example. I don't remember the number. But when FAS 133, when we talked to the FASB, and when they wrote FAS 133, what they told us verbally was confirmed with what they had written--the two ways that they had talked—
Q: When you noticed that it was removed from FAS 133 subsequently, did you discuss it any further with the FASB?
A: We did not go back and discuss that with the FASB. We discussed that with our auditors.

Responsibility for "Aggressive" Positions – Accounting policy decisions are determined almost unilaterally by Jonathan Boyles and members of his Financial Standards team. As noted above, certain accounting positions taken by Fannie Mae are contrary to GAAP and at times described as "aggressive interpretations."[239] Taking SFAS 133 accounting positions characterized as aggressive or not in compliance with GAAP appears to be motivated by management objectives of minimizing earnings volatility and ensuring simplicity of operations. Based on information and testimony OFHEO has obtained, it appears that Jonathan Boyles has responsibility for accounting policy decisions made by Fannie Mae that resulted in the improper application of SFAS 133.

Summary of Key Issues Identified

There are several issues that have been identified by OFHEO, most of which represent misapplications of the hedge accounting requirements of SFAS 133. Given that the special examination is continuing, the items outlined below should not be considered an exhaustive list of issues identified in connection with Fannie Mae's application of SFAS 133. These broader issues, which affect a large number of Fannie Mae's derivative transactions, are discussed in greater detail in the remaining sections of this report:

Issue 1: Fannie Mae improperly assumes that derivatives continue to be perfectly effective hedges upon their re-designation into new hedging relationships. When existing derivatives are re-designated, they generally do not have a fair value of zero when the new hedging relationship is established. As such, they violate one of the requirements under SFAS 133 for the assumption of no ineffectiveness. This issue is prevalent for most derivatives associated with term-outs, which represent a large portion of Fannie Mae's derivatives portfolio.[240]

Issue 2: The accounting for offsetting derivatives was inappropriate from the adoption of SFAS 133 through the end of 2003. The Enterprise often entered into offsetting swaps rather than terminating an existing swap. The original swap and the offsetting swap were incorrectly treated as perfect cash flow hedges and their changes in fair value were recorded in Accumulated Other Comprehensive

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Q: So you did not change your accounting as a result of the amendment made by the FASB; is that correct? And this was before you applied FAS 133; is that correct? The amendment was made prior to you having applied FAS 133.
A: I believe it was. I forget the date.

[239] See Issue 3 herein: Application of Shortcut and Matched Terms Method, Additional Transaction Examples, Receive-Fixed Swaptions, for more details on the email from Jonathan Boyles referenced above, in which the term "aggressive interpretations" is used.

[240] Email from Pete Barbera to Jonathan Boyles, Subject: Inventory of FAS 133 transactions, June 2, 2004, produced via CD 8/11/04 in M Box. Attached to Mr. Barbera's email was a draft schedule titled "Analysis of the March 2004 Book." The draft analysis categorized approximately $960 Billion of Fannie Mae's notional outstanding derivatives by transaction type (per the DAG) and by hedge classification (CF, FV, DNQ and Other) as of the end of March 2004. The thirteen most frequently used transactions presented in Mr. Barbera's analysis match those presented in a letter by Jodie Kelley, Vice President and Deputy General Counsel, to Chris Dickerson, July 28, 2004, FMSE 00083. They are 1, 2, 3, 4, 8, 10, 11, 12, 13, 20, 52, 67 and 71. Of these, OFHEO has identified that 5 are term-out transactions and comprise approximately $240 billion of the over $960 billion of outstanding derivative notional balances at March 31, 2004.

Income ("AOCI"). Instead, hedge accounting should have been discontinued and changes in fair value should have been recorded in earnings. Effective the first quarter of 2004, Fannie Mae modified its accounting for these offsetting swaps, with the new accounting method being applied prospectively.[241]

Issue 3: Fannie Mae has incorrectly applied the "short-cut" method (or "matched terms" method) in a number of situations. The following are those discussed in this report:

- Receive-fixed swaptions hedging the fair value of debt are incorrectly accounted for as perfect hedges, even though ineffectiveness would generally be expected to exist in such relationships.
- Callable swaps hedging discount notes are incorrectly treated as perfectly effective without regard to the option value existing in the derivative but not in the hedged item.
- Perfect effectiveness in hedges of anticipated debt issuances has been assumed based upon a duration comparison which is not supported by SFAS 133.
- Swaps arising from the exercise of a swaption are treated as perfectly effective despite having a non-zero fair value at inception.
- The requirement for matching of reset dates (in order to assume perfect effectiveness) between the hedged item and the swap in cash flow hedges has been modified in the Enterprise's policy to permit up to a seven day reset date mismatch.
- The requirement for matching of maturity dates (in order to assume perfect effectiveness) between the hedged item and the swap in fair value hedges has been modified to permit up to a 90 day mismatch.

Issue 4: Beginning with its initial adoption of SFAS 133, Fannie Mae employed an erroneous methodology to account for changes in the time value and intrinsic value components of purchased interest rate caps. In November 2002, the Enterprise discovered the error, corrected its methodology, and applied the new methodology only to new interest rate caps prospectively. The accounting for previously existing caps was not corrected and previously reported accounting results were not evaluated for possible restatement. In its 2002 10-K, Fannie Mae described this as a refinement of its methodology rather than a correction of an error.

Issue 5: OFHEO has identified a number of problems with Fannie Mae's hedge documentation with respect to its compliance with hedge accounting requirements. In several examples reviewed by OFHEO, the documentation was ambiguous as to the nature of the hedging relationship or did not clearly identify the hedged risk, hedged item or its probability of occurrence – all required under SFAS 133 to meet the hedge accounting criteria. In addition, OFHEO noted instances of a lack of contemporaneous documentation, such as the occurrence

[241] Memorandum from Jonathan Boyles to Distribution, Subject: Revisions to the December 2003 DAG, March 13, 2004, FMSE 113686-113690.

of retroactive hedge designations and the lack of adequate documentation when a re-linkage (re-designation) occurs.

Implications of Issues Identified

From our review of documents, emails, testimony and initial interviews with Fannie Mae personnel, OFHEO has concluded that there has been an intentional effort by management to misapply the accounting rules as specified in the standard in order to minimize earnings volatility and simplify operations.

By improperly assuming perfect effectiveness for many of its hedges, Fannie Mae has failed to perform the proper assessment of effectiveness and measurement of ineffectiveness in these instances. Furthermore, the Enterprise has many deficiencies in its hedge designation documentation. Effectiveness assessment, ineffectiveness measurement and proper hedge documentation are critical pre-requisites to receive hedge accounting treatment under SFAS 133. Because the Enterprise has not met these criteria, it should not receive hedge accounting treatment for many of its derivatives. Instead, the proper accounting for such derivatives would be for their fair value changes to be recorded directly through earnings.

Prior to 2004, Fannie Mae improperly accounted for certain offsetting derivatives, treating them as hedges when they did not qualify as such. Additionally in 2001-2002, Fannie Mae improperly accounted for certain purchased interest rate caps which may have significantly misstated the Enterprise's earnings and AOCI during those years. These instances raise further questions about possible misstatements of prior years' financial results. These matters also raise concerns about Fannie Mae's financial reporting and disclosures:

- Fannie Mae was aware that their prior accounting treatment for offsetting derivatives was not consistent with GAAP. When this accounting treatment was changed in the first quarter of 2004, no mention was made of a possible misstatement of prior years' financial statements or the amounts of such prior misstatements. Fannie Mae disclosed in the first quarter 2004 10-Q that the impact of classifying certain derivatives as non-hedging was approximately $13 million on that quarter's pre-tax net income. [242] While the actual impact on prior periods is unclear, OFHEO believes it could have been larger, because the mark-to-market impact on earnings in the first quarter 2004 has been dampened by efforts to actively manage the undesignated derivatives portfolio. Irrespective of the amounts involved, this is an instance in which Fannie Mae knowingly applied improper accounting which furthered their objective of minimizing earnings volatility.

- In 2002, the Enterprise disclosed a change of methodology in its accounting for changes in time and intrinsic value of purchased interest rate caps. It did not disclose the improper accounting resulting from the earlier approach. OFHEO believes that Fannie Mae's disclosure in the 2002 10-K was not adequate to provide a reader with a complete understanding of the matter, or to enable them to discern that errors had occurred in prior periods. Fannie Mae did not address the correction of this error. Instead Fannie Mae changed its accounting for new transactions

[242] Fannie Mae March 31, 2004 10-Q, p. 26.

prospectively, and did not evaluate the impact on prior periods or transactions that existed at the time the change was made.

As of December 31, 2003, the balance in AOCI reflects $12.2 billion in deferred losses relating to cash flow hedges. [243] Furthermore, carrying value adjustments of liabilities relating to fair value hedges amounted to $7.2 billion as of that date.[244] The matters noted herein with respect to improper application of hedge accounting leads OFHEO to question the validity of the amounts reflected in AOCI; as well as amounts reflected as carrying value adjustments, at any point in time since the adoption of SFAS 133. For hedges which do not qualify for hedge accounting, fair value changes should be reflected in earnings in the period in which the value change occurred, with no offset to AOCI or hedged item carrying value. Additionally, the possible reclassification of these amounts into retained earnings could have a substantial impact on Fannie Mae's compliance with its regulatory capital requirements. In order to determine the actual impact of the matters discussed herein, a substantial investment of resources and management's commitment will be required.

[243] Fannie Mae December 31, 2003 10-K, p. 80.
[244] Fannie Mae December 31, 2003 10-K, p. 146.

Issue 1: Derivative Re-Designations

Fannie Mae uses a variety of derivative instruments to hedge its interest rate risk. Due to the dynamic nature of Fannie Mae's portfolio, hedging instruments are regularly de-designated from old hedging relationships and re-designated into new hedging relationships as the portfolio changes. This section discusses Fannie Mae's assumption of perfect effectiveness in its hedging relationships when such re-designations occur.

Background

SFAS 133 requires an entity applying hedge accounting to perform an assessment to demonstrate a highly effective hedge relationship both at inception and on an on-going basis, unless the relationship meets the requirements of the short-cut method[245] or where the critical terms of the hedging instrument and the hedged items match[246] such that there will be no ineffectiveness in the hedge relationship and the changes in the fair values or cash flows of the hedged item are expected to completely offset those of the derivative. [247] The concept of hedge effectiveness is important under SFAS 133 in two respects:

- The assessment test is required in order to qualify for hedge accounting. It must be performed at the inception of a hedge relationship and throughout its life on at least a quarterly basis to demonstrate that the hedge has been, and is expected to continue to be, "highly effective." [248]
- Even though a hedge relationship may be deemed highly effective and qualify for hedge accounting, ineffectiveness may exist in the hedging relationship. Ineffectiveness represents the extent to which changes in the fair value of the derivative are not perfectly matched with the changes in fair values or cash flows of the hedged item. The ineffective portion of changes in the derivative's fair value must be recorded in earnings.

A perfect cash flow hedge has the effect of deferring the recognition of a change in the derivative's fair value in the income statement, by recording all changes in value in AOCI and recording no ineffectiveness in the income statement. A perfect fair value hedge results in changes in fair value of the derivative being offset by equal changes in fair value of the hedged item, resulting with zero ineffectiveness in the income statement. Fannie Mae's predominant approach is to assert that their hedge relationships are perfectly effective due to the matching of critical terms. We will refer to this as the "matched terms" approach.

Summary of Issue

Fannie Mae frequently de-designates and re-designates hedge relationships as it goes through the process of re-balancing its liability portfolio. In most instances, the re-designation is caused by a term-out, which is a phrase used by Fannie Mae generally to describe the replacement of discount notes with fixed rate notes or different floating rate borrowings. When a derivative is

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[245] FASB, SFAS 133, paragraph 68, as amended. This paragraph discusses the requirements of the shortcut method.

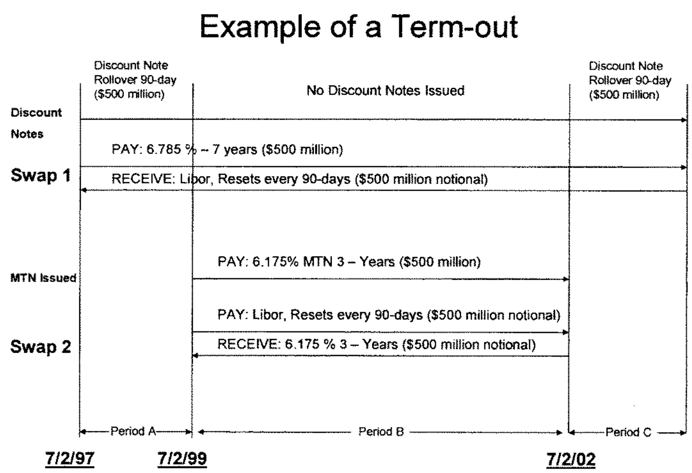
[246] FASB, SFAS 133, paragraph 65, as amended. The concept of matching of critical terms is discussed in this paragraph.

[247] FASB, SFAS 133, paragraphs 20 (b) and 28 (b), as amended, for fair value and cash flow hedges, respectively.

[248] FASB, SFAS 133, paragraphs 20 and 28, as amended, which relate to fair value and cash flow hedges, respectively.

re-designated due to a term-out, it is the beginning of a new hedging relationship. This requires an entity to evaluate the effectiveness of the new hedge relationship, including consideration of whether the matched terms approach may be applied. As discussed in greater detail below, one of the criteria that must be met in order to apply matched terms accounting is that the fair value of the hedging instrument at the inception of the hedging relationship be zero. When an existing derivative is re-designated, it would typically have a fair value that is not zero, due to market changes that have occurred since the instrument's inception. Thus, it is generally not possible to qualify for matched terms treatment upon the re-designation of a hedging instrument. Nonetheless, Fannie Mae continues to apply matched terms accounting when such situations occur. **It is OFHEO's conclusion that Fannie Mae has improperly applied matched terms accounting to derivatives that have been subject to re-designation in connection with term-out transactions. By incorrectly applying matched terms accounting, Fannie Mae has not only failed to measure the ineffectiveness associated with such relationships but they have failed to perform a proper hedge effectiveness assessment, which invalidates their ability to receive hedge accounting treatment.**

Example 1.
Below is an example of a term-out and its effect on the associated swap for purposes of illustrating a typical re-designation that Fannie Mae executes as part of their portfolio rebalancing.



Special Examination of Fannie Mae
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Description of Transaction:

- *On 7/2/1997, Fannie Mae issues $500M in Discount Notes ("DN") and enters into Swap #1 (treated as a "perfect" cash flow hedge of the forecasted interest payments on the discount notes). Swap #1 is a pay-fixed, receive-floating swap with a term of 7 years, the period of expected reissuance of DNs. For purposes of this example it is assumed that the swap's interest rate reset dates match the expected timing of DN reissuance and all other critical terms are matched in order to allow Fannie Mae to assume perfect effectiveness under SFAS 133.*
- *On 7/2/1999, Fannie Mae issues $500M 6.175% 3-yr Medium Term Note ("MTN") rather than reissuing $500M in DNs. At that time Fannie Mae also enters into swap #2. Swap #2 is a receive-fixed, pay-floating swap that matures in three years. Swap #2 is structured such that its cash flows offset those of swap #1 for the three year term of swap #2 (period B in the illustration), with the exception of a differential between the fixed rates of the two swaps, which remains constant during that period.*
- *Upon the maturity of the MTN, Fannie Mae expects to resume issuing $500M in DNs through the remainder of the original 7 year period (period C in the illustration).*
- *On 7/2/1999, Fannie Mae de-designates swap # 1 from its original hedge relationship and re-designates it, in combination with swap#2, as a "perfect" cash flow hedge of the anticipated rollover of $500M of DNs during a future period (period C, which is the period of time in which the MTN matures and a $500M DN is issued again). As of 7/2/1999, the re-designated swap #1 together with swap #2 is hedging a "forward starting" two year period that begins 7/2/2002.*

In Fannie Mae's DAG, the accounting treatment described for the re-designated hedge relationship set forth above, and other similar re-designations, is matched terms accounting. In many of the transaction examples involving term-outs and re-designations as set forth in the DAG, their descriptions indicate an assumption of no ineffectiveness. Based on OFHEO's interviews with Mr. Boyles and other accounting personnel, as well as our reading of the Enterprise's DAG, we understand that in such instances, Fannie Mae has applied the guidance in DIG Issue No. G9 *Cash Flow Hedges: Assuming No Ineffectiveness When Critical Terms of Hedging Instruments and Hedged Transaction Match in a Cash Flow Hedge* ("DIG Issue G9"), and paragraph 65 of SFAS 133, to assume perfect effectiveness. Moreover, we understand that in these circumstances Fannie Mae performs no assessment test and no measurement of ineffectiveness, which results in the earnings effect of these transactions being the same as the synthetic accounting treatment that Fannie Mae followed prior to SFAS 133. [249] OFHEO asserts that this accounting is not consistent with the requirements of SFAS 133.

[249] For example, "Termout Transaction #2" in Fannie Mae's DAG, states that "changes in fair value of the re-designated portion of Swap #1 and all of Swap #2 will be reported in [Accumulated] Other Comprehensive Income" and that "This accounting treatment will have the effect of keeping the original accrual rate in earnings equal to what would have been recognized under synthetic accounting treatment."

Accounting Analysis
Paragraph 65 of Statement 133 states:

> If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in the fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective and that there will be no ineffectiveness to be recognized in earnings if:
>
> a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.
> b. **<u>The fair value of the forward contract at inception is zero.</u>** [Emphasis added]
> c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in earnings pursuant to paragraph 63 or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

DIG Issue G9 further expands on the method of matched terms. It states an entity is still required to perform and document an assessment of hedge effectiveness at the inception of the hedging relationship and on an on-going basis throughout the hedge period, however subsequent assessments can be performed by ***<u>verifying and documenting</u>*** whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review. Furthermore, the following excerpt from DIG Issue G9 should be noted:

> However, **<u>if the critical terms of the hedging instrument or the hedged forecasted transaction have changed</u>** [Emphasis added] or if there have been adverse developments regarding the risk of counterparty default, the entity must measure the amount of ineffectiveness that must be recorded currently in earnings pursuant to the guidance in Statement 133 Implementation Issue No. G7, "Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied." **<u>In addition, the entity must assess whether the hedging relationship is expected to continue to be highly effective (using either a dollar-offset test or a statistical method such as regression analysis).</u>** [Emphasis added]

When Fannie Mae re-designates a derivative in the manner described in the example above, there has been a change in both the hedging instruments used as well as the hedged transaction. Thus, upon re-designation this represents a new hedge relationship.[250] Accordingly, the requirements of paragraph 65, to assume critical terms matching, need to be evaluated in connection with the newly designated hedge relationship. In the term-out example (Example 1), on the date of re-designation, Swap #1 would presumably have a fair value other than zero,

[250] As noted in the example, Fannie Mae starts with one swap hedging the rollover of existing and future discount notes. After the re-designation, it is using two swaps in combination to hedge anticipated issuance of discount notes in a future period.

whereas Swap #2 would presumably have a fair value of zero.[251] As a result of the combination of the Swap #1 and Swap #2 having a fair value not equal to zero, the hedge does not meet the requirements of paragraph 65(b) as stated above. In addition to being specifically listed in paragraph 65(b), the concept of a zero fair value at inception as a requirement for demonstrating a matching of critical terms is noted in DIG Issue G9 and is also a requirement for the shortcut method, which is a concept similar to the matching of critical terms.[252]

Example 8 in SFAS 133, set forth in paragraphs 153-161, contains an example transaction – Scenario 2 - that specifically illustrates this point. This transaction illustrates a situation very similar to a term-out, involving the re-designation of an existing swap in combination with another swap. Relevant excerpts of that example are as follows:

> MNO Company enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable interest payments on a series of $5 million notes with 90-day terms. MNO plans to continue issuing new 90-day notes over the next five years as each outstanding note matures. The interest on each note will be determined based on LIBOR at the time each note is issued. Swap 1 requires a settlement every 90 days, and the variable interest rate is reset immediately following each payment. MNO pays a fixed rate of interest (6.5 percent) and receives interest at LIBOR. MNO neither pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is $5 million, and it expires in 5 years.
>
> Because Swap 1 and the hedged forecasted interest payments are based on the same notional amount, have the same reset dates, and are based on the same benchmark interest rate designated under paragraph 29(h), MNO may conclude that there will be no ineffectiveness in the hedging relationship (absent a default by the swap counterparty).
>
> Scenario 2—Two Interest Rate Swaps Designated as a Hedge of Future Variable Interest Payments
>
> At the end of the second year of the 5-year hedging relationship, MNO discontinues its practice of issuing 90-day notes and issues a 3-year, $5 million note with a rate of interest that adjusts every 90 days to the prime rate quoted on that day. Swap 1 is no longer effective as a cash flow hedge because the receive-variable rate on the swap is LIBOR, and the prime rate and LIBOR are expected to change differently. Thus, the cash flows from the swap will not effectively offset changes in cash flows from the three-year note.
>
> Rather than liquidate Swap 1 and obtain a separate derivative to hedge the variability of the prime-rate-based interest payments, MNO enters into a pay-LIBOR, receive-prime basis swap. The basis swap has a $5 million notional amount and a 3-year term and requires a settlement every 90 days. **MNO designates Swap 1 and the basis swap in combination as the hedging instrument in a cash flow hedge of the variable**

[251] These presumptions are based on the nature of typical interest rate swaps, which start with a fair value of zero, and thereafter have a positive or negative fair value, depending upon changes in interest rates.
[252] OFHEO has observed that Fannie Mae's policies cite criteria similar to the SFAS 133 shortcut criteria as a basis for matching of critical terms. These can be found in the DAG section IV.20 for cash flow hedges and section VI.13 for fair value hedges. See DAG, FMSE 112567-113143.

> **interest payments on the three-year note.** [Emphasis added] On the three-year note, MNO pays interest at prime. On the basis swap, MNO receives interest at prime and pays interest at LIBOR. On Swap 1, MNO receives interest at LIBOR and pays interest at 6.5 percent. Together, the cash flows from the two derivatives are effective at offsetting changes in the interest payments on the three-year note. Changes in fair values of the two swaps are recognized in other comprehensive income and are reclassified to earnings when the hedged forecasted transactions (the variable interest payments) affect earnings (as required by paragraph 31).

SFAS 133, as originally drafted, also contained the following sentence at the end of the above example (paragraph 161):

> Because the two swaps in combination meet the conditions discussed in paragraph 68, MNO is permitted to assume no ineffectiveness and use the shortcut method illustrated in Example 5.

However, when SFAS 133 was amended by Statement of Financial Accounting Standards No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities, an amendment of FASB Statement No. 133*, ("SFAS 138"),[253] the above sentence was deleted. Paragraph 38 in SFAS 138's "Background Information and Basis for Conclusions" states:

> This Statement also deletes the last sentence of paragraph 161 **because the hedging instrument in Example 8 does not meet the criterion in paragraph 68(b) to qualify for the shortcut method. The hedging instrument does not have fair value of zero at inception of the hedging relationship.** [Emphasis added.]

This example and the subsequent correction made by SFAS 138 clearly indicates that under SFAS 133, re-designated derivatives do not qualify for shortcut or matched terms treatment if their fair value is other than zero at the time of the re-designation. **Accordingly, it is OFHEO's conclusion that Fannie Mae incorrectly applies matched terms accounting in the term-out example discussed previously as well as in numerous other term-out transactions described in its DAG. By incorrectly applying matched terms accounting, Fannie Mae has not only failed to measure ineffectiveness associated with such relationships but they have failed to perform a proper hedge effectiveness assessment, which invalidates their ability to receive hedge accounting treatment.**

Further, it should be noted that Fannie Mae's DAG includes guidance on assuming perfect effectiveness. OFHEO noted that Fannie Mae's internal guidance is consistent with the accounting literature with regard to the requirement that the fair value of the hedging instrument must be zero at the inception of the hedge relationship, as well as references to DIG Issue G9.[254] Thus, **Fannie Mae's assumption of perfect effectiveness upon a hedge re-designation is not only inconsistent with SFAS 133 guidance, it is inconsistent with Fannie Mae's own internal accounting guidance. The DAG also requires a**

[253] SFAS 138 was issued in June 2000 and amended SFAS 133 for certain technical matters prior to the effective adoption date of SFAS 133 by Fannie Mae.
[254] Fannie Mae DAG pp. IV.20 – IV.24 for cash flow hedges and VI.13 - IV.15 for fair value hedges. See DAG, FMSE 112652-112656.

quantitative assessment of effectiveness to qualify for hedge accounting, as well as measurement of ineffectiveness, when matched terms criteria are not met.[255] Although, these requirements are documented in the DAG, Fannie Mae has not performed such assessments and measurements for hedges involving re-designated derivatives.

Implications

The improper accounting for re-designations as described above impacts a substantial portion of Fannie Mae's derivatives portfolio. Based on our review of Fannie Mae's DAG, many of the re-designated hedge relationships as described therein would not qualify as perfect hedges for reasons similar to those outlined for the transaction discussed in Example 1. Although further information needs to be gathered to gain a full understanding of the magnitude of these errors, OFHEO understands that as much as 50-75% of Fannie Mae's derivatives portfolio may have been subject to re-designations at some point in time.[256] Additionally, in testimony to OFHEO, the senior financial analyst in the Treasury Middle Office stated that hedge effectiveness assessment and ineffectiveness measurement is performed for only a very small number of hedge relationships relative to the total portfolio, and all others are assumed to be perfectly effective.[257] Because a proper effectiveness assessment is apparently not performed for the re-designated hedge relationships, they would not qualify for hedge accounting under SFAS 133. Such transactions would thus be properly accounted for on a "non-hedge" basis, meaning fair value changes are recorded directly to earnings.

During an interview with Mr. Boyles, he stated that Fannie Mae was aware that the sentence referenced above ["Because the two swaps in combination meet the conditions discussed in combination meet the conditions discussed in paragraph 68, MNO is permitted to assume no ineffectiveness and use the shortcut method illustrated in Example 5"] was deleted by SFAS 138. He further stated that Fannie Mae had performed an analysis prior to its adoption of SFAS 133 to evaluate the impact of the change, and based on the results of this analysis, decided to continue using the assumption of no ineffectiveness and therefore ignoring the change made in SFAS 138. Mr. Boyles stated that the difference between assuming perfect effectiveness and

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[255] Fannie Mae DAG p. IV.25 for cash flow hedges and VI.16 for fair value hedges. See DAG, FMSE 112657,112768, respectively. OFHEO observes that Fannie Mae's DAG calls for the use of a cumulative dollar offset test (80-125% is regarded as highly effective) to assess effectiveness in situations where the "long haul" method is required. Long haul method refers to situations in which neither the shortcut nor matching of critical terms method is applicable and an assessment of hedge effectiveness and measurement of ineffectiveness is required.

[256] Internal notes prepared by OFHEO, Re: Interview with Laura Simmons—Treasury Office Operations, May 20, 2004. In the interview she indicated that 50%-75% of the portfolio of derivatives is potentially re-linked.

[257] OFHEO interview, Katarina Skladony, Senior Financial Analyst-Treasury Middle Office, August 26, 2004, p. 150

A: As I recall, as of the end of the last quarter, there were no transactions for which you would have to use hypothetical derivative method for ineffectiveness calculation.

Q: So were there no long haul calculations being performed for the last quarter?

A: There were no cash flow hedges that would require long haul calculation.

See Mona Patel testimony in; The Assumption of Perfect Effectiveness, herein, for more details relating to the number of long hauls performed.

the amount of ineffectiveness measured using the long haul method was minor.[258] In the same interview, he represented that he believed that any ineffectiveness that was ignored by Fannie Mae in term-out transactions was immaterial based on the analysis performed. He also indicated that he no longer had the analysis as he had discarded it, along with several other items, when he moved offices.[259] Mr. Boyles also acknowledged that there was no quarterly or annual review of the ineffectiveness resulting from term-out transactions.

In a subsequent interview, Mr. Boyles stated that a recent analysis had been performed using information as of June 30, 2004. He informed OFHEO that this analysis was performed as a direct result of some of the issues that were raised by OFHEO as part of this special examination. He also stated that the amount of cumulative ineffectiveness resulting from re-designated derivatives was approximately $50 million. Fannie Mae's auditor, KPMG, had posted a "review difference" for this amount.[260] OFHEO obtained a summary analysis (which had no supporting documentation attached) which was used to project the ineffectiveness calculation across the entire population. OFHEO also participated in a conference call with Fannie Mae in which representatives of the Enterprise attempted to explain the methodology that was followed in completing the analysis.[261] Mr. Boyles stated that the revised projected economic

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[258] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Standards and Corporate Tax, August 3, 2004, pp. 212-213

Q: [...]So when this change was made as a result of FAS 138, is our understanding correct that a conscious decision was made to continue to apply the treatment irrespective of this change?

A: When 138 was released we also saw that sentence deleted. The background information refers to this as not qualifying for the shortcut method. It did not say that the--in the matching concept, that the--one of the critical terms was the beginning value starting with zero. This only refers to--and the criteria relates to the shortcut method. [...] We also did some analysis that I believe I mentioned earlier, that we showed our auditors, as it relates to this transaction, that showed that difference between going long haul and assuming no ineffectiveness to be minor.

[259] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Standards and Corporate Tax, August 3, 2004, pp. 225-226

Q So was that what your example was, an example of not applying matched terms but actually doing long haul?

A: [...]The analysis that we did was the analysis as it relates to if I'm going to take the income amount out of OCI, and if I'm going to record the ineffectiveness as expense, and book both of them to the income statement, that that analysis showed those amounts to be immaterial difference. And so the accrual that will normally occur will capture those differences. And that's what the policy reflects.

[...]A:[...]Several years ago when I took over the Tax Department, I switched offices, and almost everything related to the adoption of 133 I threw in the trash[...]and so I could not find it in my analysis. [...]

[260] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Standards and Corporate Tax, August 24, 2004, p. 106

Q: Was the difference, a $50 million difference, proposed as an adjustment by KPMG or was that not proposed?

A: It was a review difference for them. [...]

A: The audit isn't done so it's not an audit adjustment. But the review was completed for the quarter so it would have been a review adjustment for them.

[261] Handwritten notes from conference call held between Fannie Mae and OFHEO, September 7, 2004. Fannie Mae explained the analysis that was performed and the approach the Enterprise took to project out the sample across the entire population. Fannie Mae was represented by Leanne Spencer, Controller; Jonathan Boyles, Senior Vice President – Financial Standards and Corporate Tax; Mark Wiener, Vice President of Risk Management; and Jodie Kelley, Associate General Counsel.

impact of the analysis was a loss of $27 million[262] and that Fannie Mae's external auditor was comfortable with the number. While the matter is still under study, our initial conclusion is that the analysis procedures performed were not adequate to support Fannie Mae's conclusion for the following reasons: [263]

- The analysis was based on a sample of 40 hedge transactions and attempts to extrapolate these results to the entire population of affected transactions, rather than performing a calculation for each affected transaction. We do not believe an accurate estimate can be made using such an extrapolation.
- Fannie Mae only evaluated cumulative ineffectiveness as of a point in time, ignoring the fact that the amount of ineffectiveness recorded in earnings on a period-to-period basis will fluctuate.
- As noted earlier, an assessment of effectiveness is required to be performed retrospectively and prospectively on a quarterly basis to qualify for hedge accounting. The analysis referenced above only addressed measurement of ineffectiveness. In the call with OFHEO, Mr. Boyles represented that the Enterprise had also performed a regression analysis as of June 30, 2004 on a select number of derivative transactions out of the 40 transactions that were included in the sample. Such an after-the-fact test does not meet SFAS 133 requirements.

In order to gain an understanding of the potential ineffectiveness that can result from a term-out transaction, OFHEO performed an analysis using an illustrative $500 million notional swap that is assumed to be subject to a term-out similar to the Example 1 Term-out described above. This analysis used actual market data to illustrate the accounting effect of such a transaction if ineffectiveness is properly measured. See Appendix III. OFHEO's analysis indicates that, while cumulative ineffectiveness can be small (or even zero) at a given period end, it can result in millions of dollars of ineffectiveness affecting earnings on a period-to-period basis for a single hedge relationship. Furthermore, our illustration indicates that if an effectiveness assessment test had been properly performed in accordance with Fannie Mae's policy, the hedge relationship could fail the 80% to 125% correlation test.[264] This would preclude the application of hedge accounting in periods in which the test failed. The following graph is summarized from OFHEO's analysis and illustrates the periodic earnings volatility that can occur when ineffectiveness is properly measured (assuming the hedge relationship qualifies for hedge accounting).

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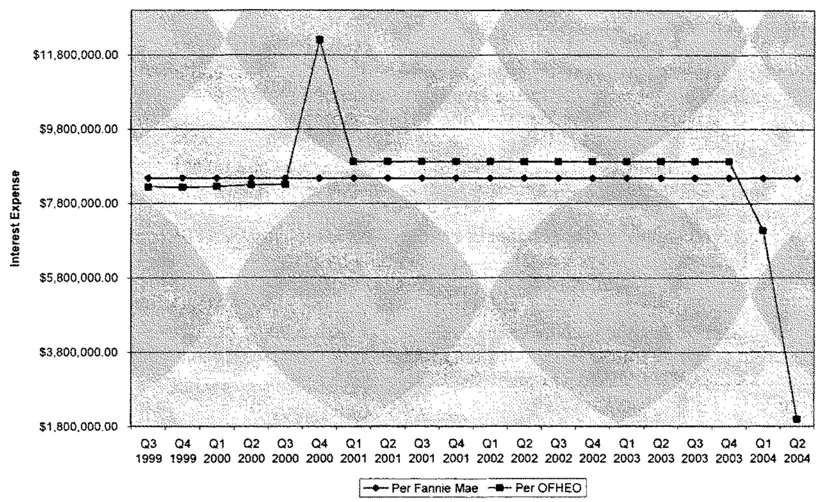
[262] Handwritten notes from conference call held between Fannie Mae and OFHEO, September 7, 2004. Fannie Mae was represented by Leanne Spencer, Controller; Jonathan Boyles, Senior Vice President – Financial Standards; and Corporate Tax; Mark Wiener, Vice President of Risk Management; and Jodie Kelley, Associate General Counsel. It is OFHEO's understanding from the call that the revised projected economic impact from the analysis was determined by Fannie Mae to be $27 million.

[263] OFHEO had requested all information that was used to prepare the analysis and develop the expectations. Fannie Mae mentioned in the call referenced above that they have been working on pulling together the information and supporting schedules that supports the analysis. This information was originally requested via a subpoena dated August 18, 2004.

[264] Fannie Mae's DAG, as well as SEC guidance, requires a dollar offset ratio between the hedging instrument and hedged item to fall between 80% and 125% in order to meet the "highly effective" requirement to qualify for hedge accounting. See section II.15-17 Hedge Effectiveness Analysis of the DAG (FMSE 112604-112606).

Illustration of Earnings Volatility - Termout



As noted above, further information and an in-depth analysis will be required to determine the proper treatment of each of Fannie Mae's hedging strategies and actual impact of these matters in relation to Fannie Mae's total derivatives portfolio for past financial statement periods. However, even without any further analysis, OFHEO contends that this matter has significant implications to Fannie Mae's financial statements given the frequent use of term-outs and the significant earnings impact. The impact that would result from recording changes in fair values of such derivatives through earnings could be in the billions of dollars.

Issue 2: Accounting for Offsetting Derivatives

Fannie Mae enters into offsetting swaps in which an existing swap (typically a pay-fixed, receive-floating swap) is effectively cancelled by a second swap with offsetting terms (i.e., pay-float, receive-fixed). This section discusses Fannie Mae's accounting treatment of these transactions and specifically the Enterprise's application of cash flow hedge accounting.

Background

SFAS 133 describes a cash flow hedge as follows: "An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale)."[265] Thus, the essence of a cash flow hedge is to offset the variability in cash flows of the hedged item.

Furthermore, SFAS 133 requires that an entity discontinue cash flow hedging **prospectively** if any one of the following occurs:[266]

- Any of the criteria to qualify for hedge accounting are no longer met.
- The derivative expires or is sold, terminated or exercised.
- The entity removes the designation of the cash flow hedge.

After a cash flow hedge has been discontinued, the effective portion of the derivative's net gain or loss shall remain in AOCI and be reclassified to earnings at the time the hedged transaction affects earnings, unless the hedged transaction is deemed probable of not occurring, in which case any gains or losses would be immediately be reclassified from AOCI to earnings.[267]

Summary of Issue

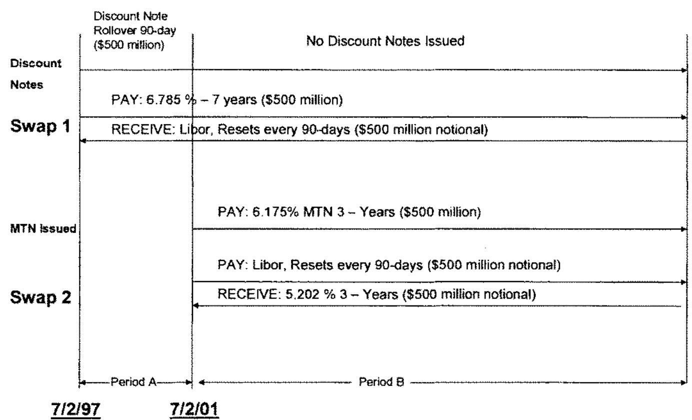
As discussed under Issue 1: Derivative Re-Designations, Fannie Mae frequently goes through the process of "re-balancing" its liability portfolio. In this process, it often enters into new swaps and other derivatives, many of which are used to offset existing derivatives either fully or partially. In many cases, this relates to a "term-out" which, as described earlier, is generally the replacement of discount notes with fixed rate notes or other borrowings. Certain term-outs result in a situation in which a hedged exposure no longer exists, for instance when short-term floating rate debt is replaced with long-term fixed rate debt and the variability of future interest payments has been eliminated. When this occurs, the swap is no longer matched to an exposure, leaving Fannie Mae with the choice of terminating the swap, offsetting it with another swap, or re-designating it to another exposure. Assuming no other exposure exists to which the swap can be re-designated, Fannie Mae's typical approach has been to enter into an offsetting swap to effectively terminate the hedging relationship. When this has occurred, Fannie Mae's past practice has been to continue to account for both swaps as a cash flow hedge, which is not consistent with SFAS 133 requirements. **It is OFHEO's conclusion that Fannie Mae has inappropriately applied hedge accounting in these circumstances. When the floating rate debt has been termed-out cash flow hedge accounting must cease because the**

265 FASB, SFAS 133, paragraph 28.
266 FASB, SFAS 133, paragraph 32.
267 FASB, SFAS 133, paragraphs 32 and 33.

hedged exposure no longer exists. The two offsetting swaps should both be recorded at fair value with changes in their fair values recorded in earnings. Although the swaps offset one another, there should still be a net mark-to-market impact because the rate on the swaps' fixed legs (one pay, one receive) would differ.

Example 2.
Below is an example of a situation in which an offsetting swap is used by Fannie Mae in connection with a term-out.

Example of an Offsetting Swap



Description of Transaction:

- *On 7/2/97, Fannie Mae issues $500M in DNs and enters into Swap #1 (treated as a perfect cash flow hedge of the forecasted interest payments on the discount notes). Swap #1 is a pay-fixed, receive-floating swap with a term of 7 years, the period of expected reissuance of DNs. For purposes of this example, it is assumed that the swap's interest rate reset dates match the expected timing of DN reissuance and all other critical terms are matched in order to allow Fannie Mae to assume perfect effectiveness under SFAS 133.*
- *On 7/2/01, Fannie Mae issues a $500M 6.175% 3-yr MTN to replace a rollover of $500M in DNs and enters into swap #2. Swap #2 is a receive-fixed, pay-floating swap that matures in 3 years which coincides with the maturity of the MTN and the end of the original 7 year hedge period. Swap #2 serves to completely offset the effect of Swap #1 except that the two swaps have different fixed interest rates because they were entered into at different times. The net result of the two swaps is a fixed stream of cash flows over their remaining lives, representing the difference in their respective fixed rates.*

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- *Fannie Mae continues to treat both Swap#1 and Swap#2 as a perfect cash flow hedge over their remaining lives and as such all changes in the swaps' fair values are reflected in AOCI and reclassified into earnings as the interest settlements on the swaps accrue.*

In Fannie Mae's DAG, they describe the above accounting treatment as "...a practical interpretation of the Statement to treat this as a cash flow hedge rather than two speculative hedges..." It states further that "This accounting will have the effect of keeping original accrual rate in earnings equal to what would have been recognized under synthetic accounting treatment."[268] OFHEO asserts that this treatment is not consistent with the requirements of SFAS 133.

Accounting Analysis
OFHEO concludes that the accounting treatment described in the above example is not compliant with the requirements of SFAS 133. As noted above, cash flow hedge accounting is applied when there is an exposure to variable cash flows. In Example 2, the exposure to variable cash flows was eliminated when the issuance of discount notes was replaced with a fixed rate MTN. Thus, at that time cash flow hedge accounting should have been discontinued for swap #1, consistent with the requirements of paragraph 32 of SFAS 133. Both swap #1 and swap #2 should have been marked-to-market through earnings from that point forward and treated as non-hedging derivatives. This conclusion is supported in SFAS 133 by "Example 8 – Scenario 1", set forth in paragraphs 153-158, excerpted as follows:

> MNO Company enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable interest payments on a series of $5 million notes with 90-day terms. MNO plans to continue issuing new 90-day notes over the next five years as each outstanding note matures. The interest on each note will be determined based on LIBOR at the time each note is issued. Swap 1 requires a settlement every 90 days, and the variable interest rate is reset immediately following each payment. MNO pays a fixed rate of interest (6.5 percent) and receives interest at LIBOR. MNO neither pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is $5 million, and it expires in 5 years.
>
> Because Swap 1 and the hedged forecasted interest payments are based on the same notional amount, have the same reset dates, and are based on the same benchmark interest rate designated under paragraph 29(h), MNO may conclude that there will be no ineffectiveness in the hedging relationship (absent a default by the swap counterparty).
>
> Scenario 1—Two Undesignated Interest Rate Swaps
>
> At the end of the second year of the 5-year hedging relationship, MNO discontinues its practice of issuing 90-day notes. Instead, MNO issues a 3-year, $5 million note with a fixed rate of interest (7.25 %). Because the interest rate on the three-year note is fixed, the variability of the future interest payments has been eliminated. **Thus, Swap 1 no longer qualifies for cash flow hedge accounting** [Emphasis added]. However, the net gain or loss on Swap 1 in accumulated other comprehensive income is not reclassified to earnings immediately. Immediate reclassification is required (and

[268] This language can be found under example transaction #43 in the DAG, FMSE 113073.

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permitted) only if it becomes probable that the hedged transactions (future interest payments) will not occur. The variability of the payments has been eliminated, but it still is probable that they will occur. Thus, those gains or losses will continue to be reclassified from accumulated other comprehensive income to earnings as the interest payments affect earnings (as required by paragraph 31).

Rather than liquidate the pay-fixed, receive-variable Swap 1, MNO enters into a pay-variable, receive-fixed interest rate swap (Swap 2) with a 3-year term and a notional amount of $5 million. MNO neither pays nor receives a premium. Like Swap 1, Swap 2 requires a settlement every 90 days and reprices immediately following each settlement. The relationship between 90-day interest rates and longer term rates has changed since MNO entered into Swap 1 (that is, the shape of the yield curve is different). As a result, Swap 2 has different terms and its settlements do not exactly offset the settlements on Swap 1. Under the terms of Swap 2, MNO will receive a fixed rate of 7.25 percent and pay interest at LIBOR.

The two swaps are not designated as hedging instruments and are reported at fair value [Emphasis added]. The changes in fair value are reported immediately in earnings and offset each other to a significant degree.

The excerpt above from SFAS 133 clearly indicates that there is no basis for applying hedge accounting after the DN's are replaced with MTNs because the variability in cash flows previously being hedged no longer exists. Furthermore, OFHEO observes that by applying hedge accounting to the two offsetting swaps, Fannie Mae was effectively hedging a derivative with another derivative, which is not permitted by SFAS 133. Paragraph 29(d) of SFAS 133 describes one of the criteria that must be met for a forecasted transaction to be designated as a hedged item in a cash flow hedge as follows:

The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.

A derivative is an asset or liability that is remeasured with changes in fair value reported in earnings; therefore, it is not eligible as a hedged item in a cash flow hedge relationship.

In March 2004, shortly after the commencement of OFHEO's special examination, Fannie Mae made a decision to de-designate or terminate certain hedging relationships that were classified as perfect cash flow hedges.[269] OFHEO understands that these hedging relationships included

[269] Memorandum from Jonathan Boyles to distribution, Subject: Revisions to the December 2003 DAG, March 13, 2004, FMSE 113686-113690. The memorandum states, "Effective January 1, 2004, any plain vanilla PF and RF swaps that are linked with matching terms will be treated as DNQ derivatives with both sides marked to market through earnings."

those strategies that combined a receive-fixed swap with a pay-fixed swap effectively canceling the pay-fixed swap (as illustrated in Example 2) and those that combined a pay-fixed swaption with a receive-fixed swaption. These relationships were previously treated as perfect cash flow hedges. Effective as of January 1, 2004, these swaps are being marked to market through earnings and are not receiving hedge accounting treatment. According to the 10-Q for the first quarter of 2004, the impact on earnings of marking to market these derivatives was a pre-tax loss of approximately $13 million.[270] OFHEO noted that this change in accounting treatment has been done prospectively. Fannie Mae has made no acknowledgement that its prior accounting was incorrect. Accordingly, OFHEO believes that they have not properly quantified the financial statement impact on prior periods.

It is OFHEO's conclusion, based on the accounting analysis above, that these offsetting swaps were not valid hedging relationships under SFAS 133 and should not have received hedge accounting once the term-out occurred. OFHEO discussed the accounting change with Jonathan Boyles to determine whether he believed Fannie Mae's prior accounting was correct. Mr. Boyles stated that he did not believe the prior accounting was in error, but he did believe it could be viewed as "aggressive."[271] Mr. Boyles indicated both in his memorandum and in our discussions that the reasons for the accounting change were primarily operational in nature. However, it should be noted that when asked to identify the exposure being hedged or the hedged item in these transactions, Mr. Boyles could not recall the exposure being hedged.[272] It is OFHEO's belief that Fannie Mae may have made the change in policy as a direct response to the special examination.

Implications

It appears that the derivative positions to which this issue relates have represented a reasonably significant portion of Fannie Mae's derivatives portfolio in prior periods. The magnitude is apparent from the Enterprise's March 31, 2004 10-Q, which shows that derivatives with notional and fair value balances of $51 billion and negative $1.6 billion, respectively, were treated as non-hedging instruments.[273] At December 31, 2003 the same derivatives balances were $43 million and $0.[274] OFHEO's understanding is that this change is primarily attributable to offsetting derivatives for which the accounting was changed in the first quarter of 2004. As noted earlier, Fannie Mae disclosed that the income statement effect of this change in the first quarter of 2004 was approximately $13 million. In initial discussions with Fannie Mae, OFHEO was led to believe that this amount might be an approximation of the potential earnings impact if the proper accounting method had been applied in prior periods. In discussions with OFHEO, Mr. Boyles expressed the view that Fannie Mae's practical interpretation of SFAS 133 would not

[270] Fannie Mae March 31, 2004 10-Q, p. 26.
[271] Internal notes prepared by OFHEO, Re: Interview with Jonathan Boyles, Senior Vice President—Financial Accounting Standards and Corporate Tax, May 20, 2004.
[272] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Standards and Corporate Tax, August 24, 2004, pp.177-178
Q: What was the exposure that was being hedged?
A: The exposure that was being hedged in this instance was the--I have to go back and think about it--I don't recall now. Going back, I don't recall what the exposure that was being hedged in this.
[273] Fannie Mae March 31, 2004 10-Q, Table 20: Notional and Fair Value of Derivatives by Hedge Designation, p. 27.
[274] Fannie Mae March 31, 2004 10-Q, Table 20: Notional and Fair Value of Derivatives by Hedge Designation, p. 27.

have resulted in a material difference had a strict adherence to SFAS 133 been followed for such transactions, and that the $13 million result in the first quarter of 2004 demonstrated this.

However, based on a review of several e-mails as well as an interview with Katarina Skladony, Senior Financial Analyst in Fannie Mae's Treasury Middle Office, OFHEO discerned that the earnings impact of derivatives that have been marked as non-hedging is actively monitored and managed by the Treasurer's group.[275] The following email from Cheryl DeFlorimonte illustrates Fannie Mae's response to the increased population of DNQ[276] derivatives resulting from the policy change:[277]

> In an effort to monitor and manage the earnings impact of the intentional DNQs, TMO was requested to generate a weekly report showing the change in the market value and the interest accrual relating to these DNQ swaps. It is my understanding that currently, TMO is not in a position to obtain weekly accruals for these DNQs from their system. As such, TMO has proposed that they provide the earnings impact report on a monthly basis until the required system enhancement is made...

This information led OFHEO to believe that the $13 million recognized in earnings in the first quarter is the result of the discontinuation of hedge accounting for those derivatives that were in offsetting positions as well as certain derivatives that had previously been in valid hedge relationships but were intentionally de-designated with the intention of minimizing the earnings impact of the offsetting derivatives. The "DNQ" book is apparently being actively managed and monitored to ensure that the earnings impact is minimal. The emails indicate that specific directions have been given to the technology group requesting the development of a weekly report to facilitate managing the earnings impact of non-hedge derivatives.

There are several points to note resulting from the above discussion. First, the Enterprise had employed improper accounting in prior periods, presumably in order to avoid the earnings volatility that might result from proper accounting treatment. There was no basis under SFAS 133 to defer the mark-to-market of the offsetting derivatives in AOCI. Secondly, Fannie Mae's

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[275] OFHEO interview, Katarina Skladony, Senior Financial Analyst – Treasury Middle Office, dated August 26, 2004, pp. 31-37 31, where she stated, "The DNQ project was initiated by the change in the accounting policy earlier this year that as a result of this, there were a number of transactions for which the hedge accounting guidelines changed in terms of how they're going to be reported, how the change of their market value will be reported, and since it included a fairly extensive number of trades, it was determined that there has to be a better process, a more comprehensive process, to make sure that, you know, all those transactions are properly identified and reported...Again, I believe that the project is a joint project between the Controller and the Treasurer's."
Q: Are you given any instructions from the front office and Treasurer's to specifically DNQ particular trades?
A: Yes, they have given me instructions such as that.

[276] DNQ is the terminology used by Fannie Mae to designate those derivative transactions that "do not qualify" for hedge accounting.

[277] Email from Cheryl DeFlorimonte to David Benson and Janet Pennewell, copy to Paul Salfi and Laura Simmons, Subject: Report on Earnings Impact from DNQs, February 27, 2004. This email is the 5th email in a chain of emails. The latest email (top of page) is an email from David Benson to Laura Simmons, Janet Pennewell, Cheryl DeFlorimone, copies to Paul Salfi, Katarina Skladony among others, Subject: Report on Earnings Impact from DNQs, March 1, 2004, produced via CD on 8/11/2004 in box M.

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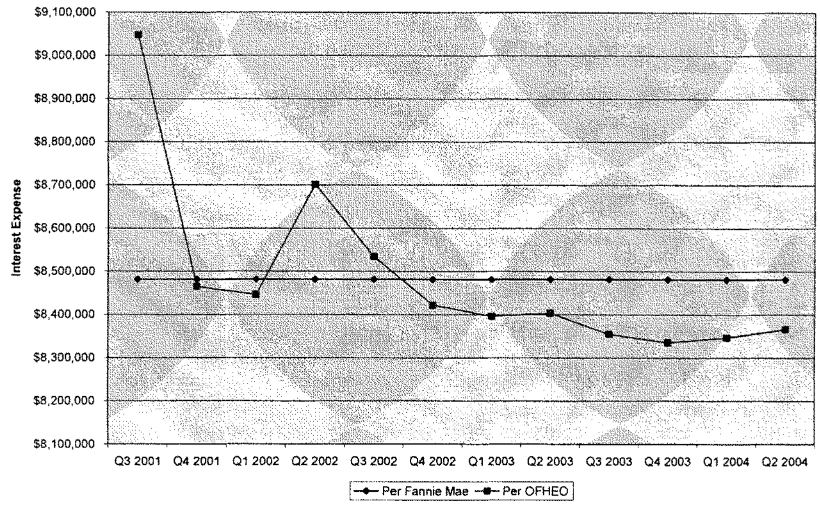
first quarter 2004 disclosure of the earnings impact of DNQ derivatives is not indicative of the potential earnings impact that would have been recognized had the proper accounting treatment been applied in prior periods. In order to evaluate the true impact on past earnings, Fannie Mae would have to perform a detailed historical analysis for all such hedge relationships and quantify the impact of applying the proper accounting treatment.

In order to gain an understanding of the potential earnings impact of marking-to-market the offsetting swaps, with changes in fair value being recorded through earnings, OFHEO performed an analysis using an illustrative transaction and historical market data. This illustrative transaction involved a $500 million, seven year pay fixed swap that was subsequently offset with a receive-fixed swap. See Appendix IV. The analysis indicates that for an individual swap, the earnings effect of marking the two swaps to market through earnings, together with the amortization of prior AOCI amounts, may in fact largely offset one another, but still result in earnings volatility. However, the impact for actual transactions may vary, depending upon the terms of the instruments involved, actual market conditions and the size of the offsetting swap portfolio. In contrast, Fannie Mae did not mark the two swaps to market, but reflected them in earnings on an accrual basis, making the earnings impact much more predictable. The following graph is summarized from OFHEO's analysis and illustrates the periodic earnings volatility that can result when the proper accounting is applied to offsetting swaps.

Illustration of Earnings Volatility - Offsetting Swaps



Fannie Mae's treatment of offsetting swaps is one of many instances in which the Enterprise has employed improper accounting, apparently in order to avoid the earnings volatility that might result from proper accounting treatment. Furthermore, explicit guidance for this type of transaction was provided by the FASB (in Example 8 in SFAS 133), in large part due to Fannie Mae's active discussions with the FASB. However, despite this guidance, Fannie Mae chose to do the accounting "their way" which provides some insight into the culture and attitudes within the Enterprise.

Issue 3: Application of Shortcut and Matched Terms Methods

Fannie Mae's use of hedge accounting relies heavily on the assumption that the vast majority of its hedging relationships are perfectly effective and that accordingly no effectiveness assessment or measurement of ineffectiveness needs to be performed for such relationships. This section discusses Fannie Mae's application of the matched terms method and the assumption of perfect effectiveness.

Background
As discussed earlier, hedge accounting under SFAS 133 requires both an assessment of hedge effectiveness (initial and on-going) in order to qualify for hedge accounting treatment, as well as measurement of the ineffective portion of the hedge through earnings. An exception is granted for certain hedging relationships involving interest rate swaps, which qualify for what is known as the "shortcut" method. If the shortcut criteria are met, an entity is permitted to assume that the hedging relationship is perfectly effective and thus perform no assessment of effectiveness and no measurement of ineffectiveness. The criteria to qualify for the shortcut method are summarized as follows:[278]

Conditions applicable to both fair value hedges and cash flow hedges:

a) The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged
b) The fair value of the swap at the inception of the hedging relationship is zero (or if applicable, reflects the fair value of an embedded call option in the swap which mirrors a call option in the hedged item).
c) The formula for computing net settlements under the interest rate swap is the same for each net settlement.
d) The interest-bearing asset or liability is not prepayable (unless it contains an embedded call or put option that is mirrored in the terms of the swap).
dd) The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.
e) Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only:

f) The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
g) There is no floor or ceiling on the variable interest rate of the swap.
h) The interval between repricings of the variable interest rate in the swap is frequent (generally three to six months or less).

Conditions applicable to cash flow hedges only:

[278] FASB, SFAS 133, paragraph 68. Information is summarized from this paragraph.

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i) All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.
j) There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)
k) The repricing dates match those of the variable-rate asset or liability.

SFAS 133 also provides that if the critical terms of the hedging instrument and of the hedged asset, liability or forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an on-going basis.[279] As a result, the entity would apply matched terms accounting. In this case there would be no ineffectiveness to record and the effectiveness assessment would consist of confirming that the critical terms are matched at inception and continue to be matched over the life of the hedge.

While the shortcut and matched terms methods appear to be similar, there are subtle but important differences in these methods:

- Under the shortcut method, the entity is allowed to *assume* no ineffectiveness in the hedging relationship, even though some ineffectiveness may exist if it were actually measured.
- Under the matched terms method, a conclusion is reached that there *is no ineffectiveness.* Thus, if the entity were to perform the measurement, no ineffectiveness would result.
- The shortcut method applies only to hedges involving interest rate swaps and existing debt instruments, whereas the matched terms method is not restricted to specific instrument types.

Summary of Issue
Fannie Mae incorrectly assumes perfect effectiveness for many of its hedge relationships. Its definitions of matched terms and shortcut criteria are not consistent with the requirements of SFAS 133. Accordingly, Fannie Mae does not perform an effectiveness assessment or measurement of ineffectiveness as required, and many of its hedging relationships therefore should not qualify for hedge accounting treatment.

Accounting Analysis
Fannie Mae's DAG sets forth requirements for assuming perfect effectiveness, which do not comply with SFAS 133 in several respects as discussed below:

[279] FASB, SFAS 133, paragraph 65, as amended.

The Seven-Day Rule: Fannie Mae's DAG allows reset dates to be mismatched by plus or minus seven days in cash flow hedging relationships and still assume perfect hedge effectiveness.[280] SFAS 133 only permits an assumption of no ineffectiveness if shortcut criteria are met or if critical terms of the derivative instrument exactly match those of the hedged item. In all other cases, effectiveness assessments and ineffectiveness measurements must be performed. This is supported by DIG Issue No. E4 *Hedging—General: Application of the Shortcut Method* ("DIG Issue E4"), which states, in part:

> Question 1: Can the shortcut method be applied if most but not all of the applicable conditions in paragraph 68 are met?
>
> Question 1 Response: No. The shortcut method can be applied only if all of the applicable conditions in paragraph 68 are met. That is, all the conditions applicable to fair value hedges must be met to apply the shortcut method to a fair value hedge, and all the conditions applicable to cash flow hedges must be met to apply the shortcut method to a cash flow hedge. A hedging relationship cannot qualify for application of the shortcut method based on an assumption of no ineffectiveness justified by applying other criteria. [Emphasis added]...

The response to question 1 goes on to say:

> The verb match is used in the specified conditions in paragraph 68 to mean *be exactly the same or correspond exactly.*

Furthermore, paragraph 65 of SFAS 133 applies only if "the critical terms of the hedging instrument and of the ... hedged forecasted transaction are the **same**..." [Emphasis added]. **Fannie Mae's use of the seven-day rule precludes it from applying shortcut or matched terms accounting to cash flow hedges for which reset dates are not exactly matched. Because Fannie Mae does not perform an effectiveness assessment or measurement of ineffectiveness for such hedge relationships, they do not qualify for hedge accounting unless the reset dates are matched exactly.**

Fannie Mae concedes that the plus or minus seven days policy is a departure from GAAP.[281] However, Fannie Mae asserts that they perform an annual analysis to determine what the

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[280] Fannie Mae DAG p. IV.22, FMSE 112654.

[281] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Accounting Standards and Corporate Tax, August 3, 2004, pp. 64-66. In the interview, Mr. Boyles stated "We have several known departures from GAAP in our adoption of FAS 133. We have cleared those with our auditors. We have reported to our auditors on an annual basis the effect of those. And they were comfortable when we adopted them, and they were comfortable over the last several years when we reported the results of that work.[...] As it relates to the plus or minus seven days, that came down to the realization in the business that we--from a business perspective we issue discount notes on an auction basis, on a weekly basis. And at times those interest rate swaps would reprice on a Monday, but we're going to issue debt on a Wednesday—[...]. And it sometimes might be on a Friday. And then, on average, it's going to be at zero, but any individual one might be off by a couple of days. And so we built this practical application as it relates to the resetting of those, partially because all of that ineffectiveness is going to roll through as you make your payments and partially because it's just the way the business is run. And so we tried to make that very narrow, that time frame in which they're allowed to do the relinkages in that."

income statement impact would be of measuring ineffectiveness that would result due to the mismatch in repricing dates had they not assumed these hedges to be perfectly effective. This analysis is prepared primarily to represent to KPMG that the difference on earnings resulting from assuming perfect effectiveness versus performing a measurement of ineffectiveness is not material. There is no hedge effectiveness assessment performed or specified in hedge documentation, as required by SFAS 133. Jonathan Boyles stated that due to Fannie Mae's assumption of no ineffectiveness, an assessment of hedge effectiveness is not necessary. OFHEO believes it is contradictory on the one hand, to acknowledge that there is ineffectiveness in the hedging relationship (which the Enterprise calculates for the external auditors) and on the other hand to assert that no assessment is required due to "assumed" perfect effectiveness.

Fannie Mae performs two analyses, the "average approach" and the "absolute value approach". An internal memorandum explains the quantitative approaches that Fannie Mae utilizes as follows:

> The first set of quantitative analysis ("average approach") incorporates the idea that there is offset between movements in LIBOR associated with pay-fixed swap funding needs which occur <u>before</u> a Benchmark Bill issuance and movements in LIBOR associated with pay-fixed swap funding needs which occur <u>after</u> a Benchmark Bill issuance. The second set of quantitative analysis ("absolute value approach") does not incorporate this idea of offset and assumes that changes in LIBOR always move against us, who we believe represents a "worst case" scenario and is highly unlikely.[282]

Both approaches, however, ignore any ineffectiveness resulting from differences in reset dates in the future. The analyses performed calculate ineffectiveness resulting only from differences in historical reset dates.

SFAS 133, DIG Issue No. G7, *Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method Is Not Applied* ("DIG Issue G7"), prescribes three methods for measuring ineffectiveness for cash flow hedges that are not eligible for the shortcut method: (1) change in variable cash flows method, (2) hypothetical derivative method, and (3) change in fair value method. The analysis performed by Fannie Mae in their quantitative evaluation of ineffectiveness does not conform to the prescribed methods in SFAS 133, and as such, may produce a different ineffectiveness result than if it had been performed using a proper method. **Thus, OFHEO contends that not only is Fannie Mae's accounting for these transactions inconsistent with SFAS 133 requirements, but also their attempt to quantify the unrecorded ineffectiveness is not consistent with SFAS 133 guidelines for performing such measurements.**

The 90-Day Rule: Fannie Mae's DAG allows maturity dates of the hedging instrument and the hedged item to be mismatched by plus or minus 90 days in fair value hedging relationships and

[282] Memorandum from Ilan Sussan to the Files, Subject: Assessing the Income Statement Impact of Applying the Plus or Minus Seven Day Policy to Fannie Mae's Average Pay-Fixed Swap Book, December 17, 2003, FMSE 032657-032658.

still assume perfect hedge effectiveness.[283] As discussed in relation to the seven-day rule, SFAS 133 only permits an assumption of no ineffectiveness if shortcut criteria are met or if critical terms of the derivative instrument exactly match those of the hedged item. As noted above, one of the criteria to assume perfect effectiveness for fair value hedges is that the maturities of the hedged item and the hedging instrument should be the same. **Fannie Mae's inclusion of the 90-day rule in its policy permits the Enterprise to apply a shortcut or matched terms approach when it does not meet the requirements under SFAS 133. Applying hedge accounting to such transactions without performing an effectiveness assessment or measurement of ineffectiveness is not permissible under SFAS 133.**

Jonathan Boyles noted that he could not recall how or why the 90-day rule was created or if it has been used by Fannie Mae in any of its transactions.[284] Further research is required to determine whether this aspect of the policy has been applied in practice and the magnitude of its impact.

Duration Matching: Fannie Mae's DAG allowed the Hedge Desk to assume no ineffectiveness in hedge relationships as long as the duration of the hedging instrument and the hedged item were matched, within certain parameters. OFHEO asserts that because the durations and other critical terms of the instruments were closely, but not perfectly matched, there should have been some resulting ineffectiveness in the relationship, requiring measurement and assessment procedures. In March 2004, Fannie Mae discontinued the use of duration matching as a method to assess the effectiveness of hedging anticipated debt issuances. Effective the beginning of the first quarter of 2004, the Enterprise began measuring and accounting for hedge ineffectiveness. [285] Mr. Boyles acknowledged that this was a departure from GAAP. [286] As such, an analysis had historically been performed on an annual basis to determine if the amounts that would have been recorded by using the long haul method would be material. Management's justification for using such an approach is that they believed "from an economic

[283] Section VI.14 of the DAG outlines the criteria required to assume no ineffectiveness for fair value hedges. Item 1 states "The expiration date of the swap matches the maturity date of the interest-bearing asset or liability that is being hedged within 3 months" (FMSE 112766).
[284] OFHEO interview, Jonathan Boyles, Senior Vice President of Accounting Standards and Corporate Tax, August 3, 2004, p. 103, in which he states "I don't recall why we have that plus or minus three months in the policy, what was the genesis of that. But presumably it was because we felt that that plus or minus three months was immaterial. I'm not aware that that's used because in a typical termout they will match the terms in a typical termout."
[285] Memorandum from Jonathan Boyles to the File, Subject: Revisions to the December 2003 DAG, March 13, 2004, FMSE 113686-113690.
[286] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Accounting Standards and Corporate Tax, August 3, 2004, pp. 64-65. In the interview, Mr. Boyles stated, that "We have several known departures from GAAP in our adoption of FAS 133. We have cleared those with our auditors. We have reported to our auditors on an annual basis the effect of those. And they were comfortable when we adopted them, and they were comfortable over the last several years when we reported the results of that work."
Q: As it relates to 133. You said there were several departures from GAAP.
A: The purpose there was really twofold: one, we felt like in the case of the duration shortcut, we felt--if you think about duration, duration is a sensitivity of an instrument's--of the instrument to interest rates. And so, you know, FAS 133 built in the concept of a shortcut so you can match notionals and match maturities and repricing dates and assume no ineffectiveness when really a better economic hedge would be to match duration, not notionals...

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standpoint, the correlation from matching durations between the anticipated debt and actual debt to be issued is better than just matching notional and payment/reset dates." [287] In 2001 and 2002, such amounts were considered to be immaterial by Fannie Mae; however, in 2003 the amount was approximately $12 million, which prompted the discontinuation of duration matching effective January 1, 2004. Duration matching is another instance where Fannie Mae has distorted the provisions of SFAS 133 to assume perfect effectiveness, though not warranted.

Use of Shortcut Criteria as a Basis for Matched Terms Accounting: The term "shortcut accounting" was noted in many instances within Fannie Mae's documentation, including the DAG, hedge designation documents and emails between Fannie Mae employees. In addition, Fannie Mae's policy requirements for assuming perfect effectiveness are based on SFAS 133's shortcut criteria, which was confirmed through an interview with Jonathan Boyles.[288] However, Fannie Mae employees have stated that they do not utilize the shortcut method as referenced in paragraph 68 of SFAS 133, and that the term "shortcut" is "loosely" used by Fannie Mae employees to describe the matched terms method, per SFAS 133 paragraph 65.[289]

Even though the special exception provided by the FASB for use of shortcut criteria is only permitted for interest rate swaps,[290] Fannie Mae's policy applies this criteria to other types of derivatives as well based on its position that such criteria results in perfect effectiveness and if those criteria are met, matched terms accounting can be applied.[291] However, OFHEO believes

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[287] Memorandum from Jonathan Boyles to the File, Subject: Revisions to the December 2003 DAG, March 13, 2004, FMSE 113686-113690.

[288] OFHEO interview, Jonathan Boyles, Senior Vice President of Accounting Standards and Corporate Tax, August 3, 2004, p. 77.
Q: Also with respect to these conditions that are used to assume no ineffectiveness, would it be fair to say that these are based upon the shortcut criteria that are outlined under FAS 133, paragraph 68, which I assume you're familiar with?
A: Mm-hmm, I believe they would be based on that.
p. 85
Q: [...]so for fair value hedges, would you agree that these criteria are based on the shortcut criteria in FAS 133?
A: Yes, I believe they're based on the shortcut criteria.

[289] OFHEO interview, Jonathan Boyles, Senior Vice President of Accounting Standards and Corporate Tax, August 3, 2004, p. 88.
Q: [...]So I guess after considering what E4 says, I'd again ask you how Fannie Mae's application of shortcut is consistent with GAAP.
FANNIE MAE LEGAL COUNSEL: When you're saying shortcut, are you talking about shortcut under 133 or what they sometimes loosely refer to as shortcut?
Q: I'm talking about how the company applies the criteria in its policy for assuming perfect effectiveness and how that's consistent with the criteria we've just looked at based on DIG Issue--
A: I would not have expressed Fannie Mae's policy to be applying the shortcut method but to be applying the terms matching.[...]

[290] SFAS 133 paragraph 68 and DIG Issue E4, question 2.

[291] Fannie Mae DAG, page IV.24, states the following with respect to cash flow hedges: "Fannie Mae also hedges the variability in cash flows by entering into certain option contracts, including caps (for liabilities), floors (for assets), and pay-fixed swaptions (for Discount Notes). Fannie Mae must meet the same criteria outlined above to assume that a hedge will be entirely effective at offsetting the hedged transaction's variability in cash flows." See FMSE 112656. Furthermore, Fannie Mae DAG page VI.15 states the following with respect to fair value hedges: "Fannie Mae also hedges the variability in fair values by entering into certain option contracts, including receive-fixed swaptions. The instrument underlying the

that in some cases, particularly fair value hedges, ineffectiveness can exist in a hedging relationship even though criteria similar to shortcut are met. For transactions not subject to the shortcut method, other items can cause ineffectiveness and must be considered in determining whether matched terms accounting can be applied.[292] Thus, in order to assume perfect effectiveness for a hedging relationship that does not meet the shortcut criteria, an entity would need to perform a calculation to demonstrate that no ineffectiveness exists. This point is described by DIG Issue E4 which states, in part:

> Although a hedging relationship may not qualify for the shortcut method, the application of regular fair value hedge accounting may nevertheless result in recognizing no ineffectiveness. For example, the characteristics of the hedged item and the hedging derivative may, in some circumstances, cause an entity's **calculation** [Emphasis added] of the change in the hedged item's fair value attributable to the hedged risk to be an amount that is equal and offsetting to the change in the derivative's fair value. In those circumstances, because there is no ineffectiveness that needs to be reported, the result of the fair value hedge accounting would be the same as under the shortcut method.

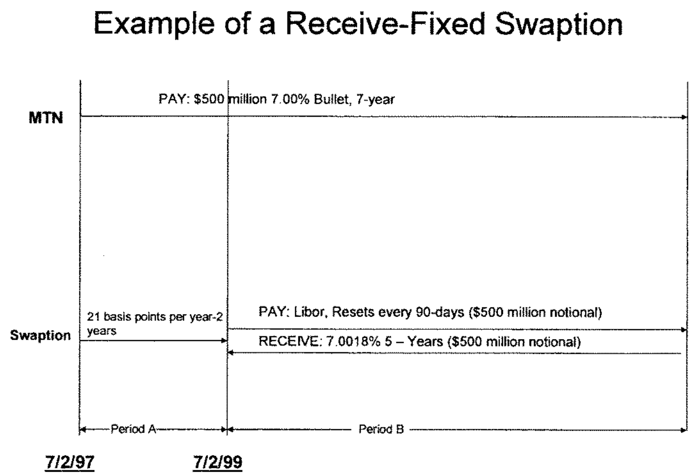
Based on the guidance discussed above, it is inappropriate for Fannie Mae to apply the short-cut criteria to derivatives other than interest rate swaps as a basis for matched terms accounting. Such treatment would only be supported if a calculation demonstrates that those criteria do, in fact, result in perfect offset between the hedging instrument and the hedged item. **Fannie Mae has not demonstrated that its application of matched terms accounting results in perfect effectiveness and has not performed an effectiveness assessment or measurement of ineffectiveness for such hedge relationships. Accordingly, they do not qualify for hedge accounting.**

Additional Transaction Examples
The following are additional examples of hedge accounting transactions for which perfect effectiveness has been incorrectly assumed yet permitted in the DAG. These examples are not a complete list of all the sample transactions contained in the DAG for which OFHEO believes the accounting policy is incorrect. The selected transactions discussed below highlight some of the frequently used transactions that have been identified as problematic during the course of the examination.

1. Receive-fixed swaption hedging a medium term note
2. Callable swap hedging discount notes
3. Discount notes hedged with funding swaps[293] and received fixed swaptions

option contract (i.e., receive-fixed swap) and the debt being hedged must meet the same criteria outlined above to assume that a hedge will be perfectly effective at offsetting the hedged transaction's change in fair value if and when the option is exercised." See FMSE 112767. OFHEO understands the references to "same criteria outlined above" to refer to the criteria outlined for interest rate swaps earlier in the DAG.
[292] Such items may include differences between the fixed rates of the hedging instrument and hedged item, intervals between interest reset dates on the hedging instrument, or changes in creditworthiness of the derivative counterparty, for example. These matters are not considered under the "shortcut" method.
[293] For purposes of this report, a funding swap is defined as a pay-fixed swap.

1. Received-Fixed Swaption Hedging a Medium Term Note



Description of Transaction:

- *On 7/2/97, Fannie Mae issues $500M in bullet debt with a 7-year maturity and enters into a swaption that gives Fannie Mae the option to enter into a receive-fixed pay-variable swap on 7/2/1999. The underlying swap is out-of-the money at the inception of the hedge, meaning its fixed rate is lower than current market rates. The underlying swap (and thus the option) will gain value as rates fall, providing protection against increases in the fair value of its debt obligation as rates fall. The option is a European style option, meaning it is exercisable at its expiration date and Fannie Mae elects to pay for the option over the two year option period. The cost is 21 basis points per year.*
- *Fannie Mae recognizes changes in the time value component of the option through earnings over the life of the option (in this case, 2 years).* [294]

[294] This election is made pursuant to SFAS 133, paragraph 63. An option's value is comprised of two elements, time value and intrinsic value. Intrinsic value represents the extent to which the option is "in the money" based on a comparison of market interest rates to the option's strike rate. Time value represents the remaining value attributed to the option contract by the market. Conceptually, time value can be viewed as the value attributed to the probability that the option could move further into the money during its life. Paragraph 63 permits companies to exclude the time value component of options and only focus on the intrinsic value in assessing effectiveness. If the time value is excluded in a valid fair value hedging relationship, then it will be recorded through earnings. The effective portion of the intrinsic value will also

- *Changes in the intrinsic value of the swaption (the value attributable to the underlying swap becoming "in the money") during Period A will be recognized in earnings along with an equal and offsetting adjustment for the change in fair value of the debt in period A. Fannie Mae treats the intrinsic value portion of the swap as being "perfectly effective."*
- *When the swap is exercised, Fannie Mae treats the new swap as a perfect fair value hedge of the change in fair values of the bullet debt during period B. As such, changes in the fair value of the swap will be recognized in earnings along with an equal and offsetting adjustment for the change in fair value of the debt in Period B.*

Hedge Accounting Issues:
The above transaction is one of Fannie Mae's thirteen most frequently used transactions.[295] In the above example Fannie Mae synthetically creates callable debt. In accounting for this transaction, Fannie Mae is a) improperly assuming no ineffectiveness during the option period (period A), and b) improperly assuming no ineffectiveness when the swaption is exercised in period B.

Issue A
In this transaction, Fannie Mae is assuming perfect effectiveness based on the assumption that critical terms are matched using "short-cut like" criteria for matching of terms. However as noted earlier, the short-cut method does not apply to instruments other than swaps (such as swaptions). Thus, in order to assume perfect effectiveness, there must be a demonstration that the fair values of the hedging instrument and the hedged item do, in fact, offset one another (see earlier discussion of DIG Issue E4). In a hedging relationship such as the one illustrated above, it is likely that there would be some ineffectiveness due to differences in the fixed rate of the underlying swap versus that of the MTN, and possibly other factors. OFHEO understands that Fannie Mae has not performed a calculation to support their claim of perfect effectiveness and has not specified any such calculation methodology in their DAG or related documentation. **As such Fannie Mae has not properly measured and assessed effectiveness for such transactions and is not in compliance with the hedge accounting requirements of SFAS 133.**

Furthermore, based on a review of the hedge designation documentation and the DAG, these documents fail to define the hedged risk in such a way to specify that the option is a one-directional hedge (i.e., to be effective as a hedge, the hedged risk would need to be defined in such a way to indicate that it provides protection against fair value changes due to decline of rates below a certain level). Fannie Mae's DAG and related designation documentation for such transactions merely describe the swaption as hedging fair value changes in the debt. With the hedged risk defined in this way, there is no basis for expecting the change in the swaption intrinsic value to perfectly offset the change in fair value of the bullet debt, because the swaption intrinsic value can fluctuate only in one direction (experiencing a gain only) whereas the value of the bullet debt can fluctuate in both directions (experiencing either gain or loss). SFAS 133 specifically requires documentation of the nature of the hedged risk and how the

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be recorded in earnings with an offsetting amount reflected in earnings as a fair value adjustment of the hedged item.

[295] Letter from Jodie Kelley, Fannie Mae Vice President and Deputy General Counsel to Chris Dickerson, OFHEO, dated July 28, 2004, FMSE1 00083, in which Ms. Kelley lists Fannie Mae's thirteen most frequent transactions.

derivative's effectiveness in offsetting that risk will be addressed. Such a description of the hedged risk is also critical to facilitating a calculation of the change in fair value of the debt attributable to the risk being hedged which would be necessary to support an effectiveness calculation as discussed above. **Fannie Mae has not properly documented the hedged risk associated with this hedging relationship and thus is not in compliance with SFAS 133's hedge accounting requirements.**

Issue B

If the swaption is exercised by the Enterprise, it would typically do so because the swaption is "in-the-money," meaning the underlying swap has a positive value. When the swaption is exercised and the swap is entered into, the assumption of no ineffectiveness cannot be made due to the swap's positive fair value at the start of the new hedging relationship (which would become a two-directional hedge, mitigating both fair value gains and losses in the debt).[296] As discussed earlier in this report, paragraphs 65 and 68 of SFAS 133 require the fair value of the hedging relationship at inception to be zero in order to assume perfect effectiveness. Therefore, in order to qualify for hedge accounting, assessment and measurement of effectiveness using the long haul method would be required. **Fannie Mae does not perform an assessment and measurement of effectiveness for swaps entered into in connection with the exercise of swaptions. Therefore, such transactions do not qualify for hedge accounting under SFAS 133.**

In our discussions with Fannie Mae about their accounting for swaptions, they expressed the view that their accounting was appropriate under SFAS 133. Yet in an email dated April 17, 2001, from Jonathan Boyles to several members of management, Mr. Boyles discusses a proposal made by the FASB relating to the accounting treatment for the time value of options. In the email, Mr. Boyles describes Fannie Mae's accounting for transactions involving receive-fixed swaptions as "aggressive." It states:

> ...the accounting treatment we currently utilize for our receive-fixed swaptions is aggressive (we have KPMG's approval) and not one we would want to flash in front of the FASB for comment or the treatment could get worse... [297]

When Mr. Boyles was asked about his reference to Fannie Mae's swaption accounting as "aggressive," he was unable to recall why he had characterized it as such. [298]

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[296] The exercise of the swaption constitutes the termination of the original hedging relationship per paragraph 25b of SFAS 133 which states that hedge accounting is discontinued when the "derivative expires or is sold, terminated or exercised." As such, a newly designated hedge relationship must be established for the swap entered into upon exercise.

[297] Email from Jonathan Boyles to several members of management, April 17, 2001, Subject: Recent FASB Proposal on the time value of options, FMSE 096460-096462.

[298] OFHEO interview, Jonathan Boyles, Senior Vice President of Accounting Standards and Corporate Tax, August 3, 2004, p. 184.

Q: Jonathan, do you recall what you meant by your "accounting treatment for receive-fixed swaptions is aggressive"?

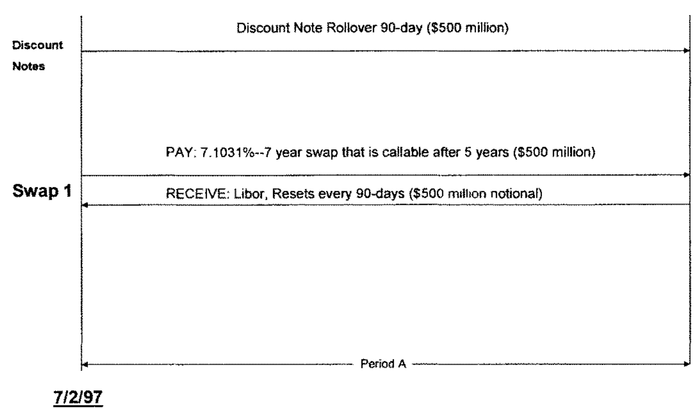
A: I don't recall what I would have meant by that. I don't know why I would have called it that because I'm not sure I would view it as aggressive.[...]

Conclusion:

It is OFHEO's conclusion that Fannie Mae incorrectly applies matched terms accounting and assumes no ineffectiveness in the receive-fixed swaption example, both before and after the swaption is exercised. In addition, as a result of incorrectly applying matched terms accounting, Fannie Mae failed to perform an assessment of hedge effectiveness, the absence of which precludes Fannie Mae from qualifying for hedge accounting for such transactions. The aggressive interpretation of matched terms is consistent with Fannie Mae's objectives of minimizing earnings volatility and simplifying operations.

2. Callable Swap Hedging Discount Notes

Example of a Callable Swap



Description of Transaction:

- *On 7/2/97, Fannie Mae issues $500M in DNs and simultaneously enters into Swap #1, which matures after 7 years.*
- *Swap #1 is callable after 5 years. This results in its gaining value as rates rise, but only losing value to a limited degree as rates fall and the call feature becomes "in-the-money."*
- *Fannie Mae treats Swap #1 as a perfect cash flow hedge during the period which it is outstanding.*
- *Changes in the fair value of Swap #1 will be recognized by Fannie Mae in AOCI in periods where Swap #1 is outstanding. Amounts in AOCI will be reclassified into earnings in the same periods during which the forecasted transaction occurs, through recognition of interest accruals and settlements on the swap.*

Hedge Accounting Issues:

There are several issues related to the above shown transaction [Example of a callable swap]. In accounting for the transaction, Fannie Mae: a) assumes no ineffectiveness although the call option embedded in the swap is not mirrored in the discount notes; b) is inappropriately recording both the intrinsic *and* time value in AOCI; and c) is improperly documenting their hedge strategy by failing to outline that the strategy is one-directional.

Issue A
Fannie Mae is treating the callable swap as a perfect cash flow hedge of the forecasted interest payments associated with the anticipated reissuance of existing and future discount notes. However, the call option in the swap is not mirrored in the hedged item. As discussed in previous sections of the report, paragraphs 65 and 68 of SFAS 133 require the critical terms of the swap to match those of the underlying hedged item in order to assume no ineffectiveness, including the call option feature.[299] Conceptually, the hedge relationship cannot be assessed as perfectly effective because the change in fair value of the swap is expected to be different than changes in cash flows of the discount notes due to the additional value of the option, which is not present in the discount notes. Generally, in order to qualify for hedge accounting, it would be necessary to separate the derivative's time and intrinsic value components, as discussed in Issue B. **Fannie Mae's assumption of perfect effectiveness for the entire change in fair value of the derivative is not consistent with the hedge accounting requirements of SFAS 133.**

Issue B
By including all changes in the derivative's fair value in AOCI, Fannie Mae is in essence assessing effectiveness using the entire value (both intrinsic and time value) of the instrument, and treating it as perfectly effective. For all other option based derivatives, Fannie Mae separates the time and intrinsic value in assessing and measuring effectiveness. When OFHEO questioned Mr. Boyles on the rationale for not separating the time value from the intrinsic value in assessing effectiveness for callable swaps, he stated that the Enterprise was following the guidance in DIG Issue G20 *Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge* ("DIG Issue G20[300]"). However, the December 2003 DAG does not make any reference to the fact that Fannie Mae had adopted DIG Issue G20, which requires specific designation language to that effect.[301] Additionally, DIG Issue G20

[299] FASB, SFAS 133, paragraph 68 (e).
[300] DIG Issue G20 states that when designating a purchased option as hedging the variability in cash flows, the assessment of effectiveness can be based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value—its entire gain or loss), rather than documenting that the assessment of effectiveness will be based on only the changes in the hedging instrument's intrinsic value as permitted by paragraph 63(a) of FAS 133.
[301] OFHEO interview, Jonathan Boyles, Senior Vice President of Accounting Standards and Corporate Tax, August 24, 2004, pp. 186-187
Q: I'd like to just get back to transaction number 32, the callable swap, and I guess the question is what were you doing--you mentioned you were applying G20. Where in the policy is it stated that you're applying G20 in your derivatives accounting guidelines?
A: It does not--I mean we'll be more explicit in our next version in the end of 2004, but the policy and the practices of G20.

states that it applies to "purchased options and combinations of only options." This language indicates that DIG Issue G20 does not apply to swaps containing embedded options. Furthermore, the initial version of the DAG, released prior to the issuance of DIG Issue G20, included the same accounting for this transaction that is being followed today. Thus, an assertion that this accounting treatment is based on DIG Issue G20 is unsupported.[302] Finally, in May 2004, we noted drafts of potential changes to Fannie Mae's DAG indicating that Fannie Mae was considering separating the time and intrinsic value for callable swaps. [303] **Fannie Mae's inclusion of both time and intrinsic value changes of the callable swap in AOCI is not consistent with the requirements of SFAS 133 or the Enterprise's own practices for other options based strategies.**

Issue C

Based on OFHEO's review of the hedge designation documentation and the DAG, these documents fail to define the hedged risk in such a way to specify that the option is a one-directional hedge (i.e., to be effective as a hedge, the hedged risk would need to be defined in such a way to indicate that it provides protection against cash flow changes due to increases in rates but only against declines in rates below a certain level – that at which the call feature is "in-the-money"). Fannie Mae's DAG and related designation documentation for such transactions merely describe the callable swap as hedging cash flows attributable to interest payments on discount notes. With the hedged risk defined in this way, there is no basis for expecting the change in the swap's fair value to perfectly offset all changes in cash flows of the discount notes, because the swap fair value would experience gains as rates rise, but would only experience losses to a limited degree as rates fall; whereas the cash outflows of the discount notes can both increase and decrease as rates rise or fall. SFAS 133 specifically requires documentation of the nature of the hedged risk and how the derivative's effectiveness in offsetting that risk will be addressed. Such a description of the hedged risk is also critical to facilitating a calculation of the change in hedged cash flows attributable to the risk being hedged in order to support an effectiveness calculation. **Fannie Mae has not properly documented the hedged risk associated with this hedging relationship and thus is not in compliance with SFAS 133's hedge accounting requirements.**

Fannie Mae was apparently aware that this accounting treatment was aggressive in 2000, one year before the adoption of SFAS 133. In an email, Kim Stone, a former employee of Fannie Mae and manager in the Financial Accounting Standards Group, wrote: "As it is, using the cancelable swap under the short-cut method is very aggressive." [304]

Conclusion:

It is OFHEO's conclusion, based on the accounting analysis above, that Fannie Mae's accounting for the callable swaps as perfect hedges, as well as the recognition of the entire option value in

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[302] OFHEO interview, Jonathan Boyles, Senior Vice President of Accounting Standards and Corporate Tax, August 24, 2004, p. 187
Q: What were you doing prior to G20 being effective?
A: We were doing the same accounting treatment.

[303] Email from Ilan Sussan, Financial Standards, to various individuals at KPMG including as an attachment *"DAG – PowerPoint Slides"*, 5/24/2004, produced via CD 8/11/04 in M box.

[304] Email from Kimberly Stone, former manager in Financial Accounting Standards, to Joseph Rosenberg, August 10, 2000, FMSE 078731-078732.

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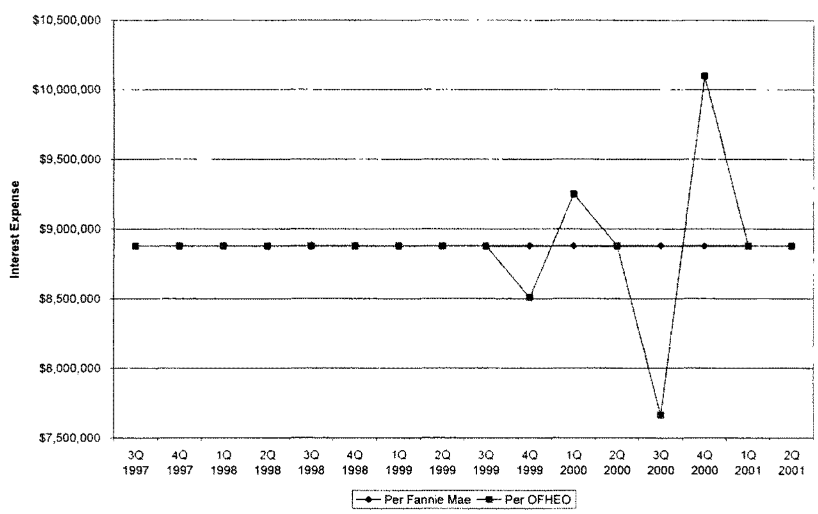
AOCI, is inappropriate. As is the case in other examples discussed herein, there was no assessment of hedge effectiveness performed, and thus, Fannie Mae should not have received hedge accounting.

For purposes of illustrating the earnings impact of not assuming perfect effectiveness, but instead measuring and recognizing ineffectiveness correctly, OFHEO prepared an illustrative transaction using actual market data to show its potential impact on earnings using a $500 million callable swap. The complete analysis can be found at Appendix V. Per OFHEO's analysis, the dollar-offset approach required by Fannie Mae's DAG for assessing effectiveness indicates that this hedging relationship could fail to qualify for hedge accounting. [305] The amount of ineffectiveness varies from quarter to quarter which would have led to additional volatility in earnings. If the hedge is not deemed highly effective (within the 80% to 125% range), hedge accounting should be terminated as of the last date the derivative was considered to be highly effective. Additionally, even if the hedge did qualify as being highly effective, the amount of ineffectiveness could fluctuate from quarter to quarter causing additional volatility in earnings. This is illustrated by the following graph, which is summarized from OFHEO's analysis.

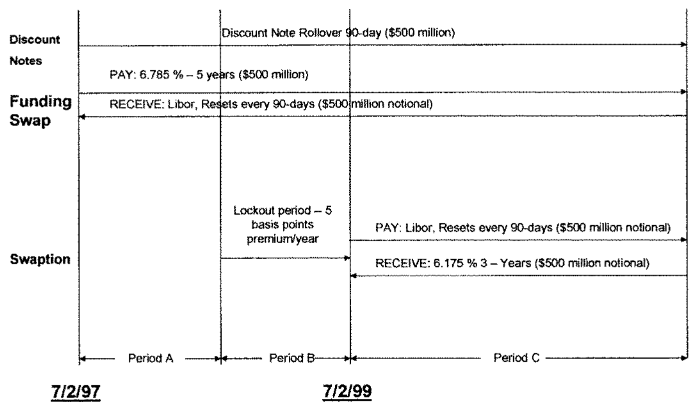
Illustration of Earnings Volatility - Callable Swap



[305] Fannie Mae's DAG, as well as SEC guidance, requires a dollar offset ratio between the hedging instrument and hedged item to fall between 80% and 125% in order to meet the "highly effective" requirement for hedge accounting, FMSE 112604-112606.

3. Discount Notes Hedged with Funding Swaps and Received-Fixed Swaptions

Example of Discount Notes Hedged by Funding Swap and Receive-Fixed Swaption



Description of Transaction:

- *On 7/2/1997, Fannie Mae issues $500 million in DNs and simultaneously enters into a pay-fixed funding swap in which they receive LIBOR.*
- *In period B, they enter into a swaption which gives Fannie Mae the option to enter into a receive-fixed swap on 7/2/1999. The cost of the option is 5 basis points per year.*
- *Fannie Mae would exercise the option if the LIBOR swap rate falls below the fixed rate on the underlying receive-fixed swap (i.e., the swaption is "in-the-money"). This would partially offset the loss on the funding swap and lower Fannie Mae's effective debt cost. This combined transaction is similar economically to using a callable swap.*
- *The combination of the receive-fixed swaption (intrinsic value only) and the funding swap would be treated by Fannie Mae as a cash flow hedge of future DN issuances. Fannie would assume no ineffectiveness because the critical terms of the combined derivatives are deemed to match the hedged debt. Changes in the time value of the option would be recorded in earnings.*
- *If the swaption is exercised, the two offsetting swaps would be treated as a perfect cash flow hedge during period C.*

Hedge Accounting Issues:

Several issues exist in the above shown transaction, most of which are similar to the issues discussed in the previous transactions. In reviewing Fannie Mae's accounting for this type of transaction, OFHEO noted the following issues with respect to the application of hedge accounting:

a. Fannie Mae separates the time and intrinsic value components of the option which is inconsistent with their treatment of the callable swap discussed above, even though the transactions are economically similar. While this treatment appears proper for this transaction, it highlights the improper treatment of time value associated with the callable swap.
b. The combined swap and swaption are treated as perfectly effective once the swaption is entered into, although the funding swap has a fair value other than zero at the inception of this new hedging relationship. As noted for other strategies described within this report, the non-zero intrinsic value of the combined instruments at inception of the hedging relationship precludes the ability to assume perfect effectiveness for this strategy.
c. The DAG and related documentation fail to document that the hedging strategy is one-directional due to nature of the option values. This issue was also noted with respect to the receive-fixed swaption and callable swap transactions discussed in this report, and violates the hedge accounting documentation requirements of SFAS 133.
d. Upon exercise of the swaption, Fannie Mae in the past continued to treat two offsetting swaps as cash flow hedges in combination, even though they do not serve to mitigate cash flow variability associated with the discount notes (because the cash flows of the two swaps offset one another). This is similar to the issue discussed relating to offsetting swaps in this report (Issue #2). This practice was discontinued by Fannie Mae in the first quarter of 2004.

Conclusions:

Based on the accounting analysis above, OFHEO has concluded that Fannie Mae's accounting for the pay-fixed swap and the receive-fixed swaption in combination as a perfect hedge is not justified under SFAS 133. Additionally, since no hedge assessment is performed, the hedge relationship should not qualify for hedge accounting. The offsetting swaps resulting from the exercise of the swaption should not have received hedge accounting in past periods and instead their changes in fair value should have been marked to market through earnings. Finally, the documentation of the risk hedged by the combined swap and swaption does not adequately reflect the nature of the hedging relationship and further calls into question Fannie Mae's hedge accounting for such transactions.

Implications

Fannie Mae's inappropriate assumption of no ineffectiveness based on its application of the short-cut or matched terms approaches set forth in its DAG and as discussed herein calls into question the accounting treatment for a significant portion of the Enterprise's derivatives portfolio. The approaches employed by Fannie Mae have not only served to reduce the earnings

volatility and lessened the operational complexity associated with the application of SFAS 133, but have potentially misstated the Enterprise's financial results in a significant way. The transactions discussed in this section for which accounting problems have been identified are among the most common strategies employed by the Fannie Mae.

While OFHEO has not quantified the effects of the misstatement on current or past periods resulting from the improper application of the short-cut or matched terms approach, from a qualitative perspective, as stated earlier, almost all of Fannie Mae's hedges receive short-cut treatment, or assume no ineffectiveness. Of the thirteen most frequent hedging transactions identified by Fannie Mae, issues relating to the concept of no ineffectiveness have been identified for seven of such transactions. As of December 31, 2003, amounts deferred in AOCI due to cash flow hedge accounting were negative $12.2 billion,[306] and carrying value adjustments of hedged items in fair value hedges amounted to approximately $7.2 billion. [307] As a result of the invalidation of hedge accounting, a significant portion of these amounts could be reversed and put into earnings. However, the determination of the exact amounts of any earnings adjustments and the periods in which they should be effected will require a substantial amount of analysis, time and resources on the part of the Enterprise.

[306] Fannie Mae December 31, 2003 10-K, p. 80.
[307] Fannie Mae December 31, 2003 10-K, p. 146.

Issue 4: Interest Rate Caps

Background
Fannie Mae purchases interest rate caps to hedge exposures to increases in interest rates on its discount notes or floating rate borrowings. Under SFAS 133, Fannie Mae applies cash flow hedge accounting to the caps and is therefore required to fair value the caps at each reporting date. To the extent effective, fair value changes are recorded in AOCI, and the ineffective portion is recorded in earnings.

To illustrate the mechanics of a purchased cap, assume Fannie Mae issues floating rate debt and does not wish to pay interest exceeding 5%. Fannie Mae can purchase an interest rate cap with a strike rate of 5% to hedge the variability in cash flows from the floating rate debt attributed to rising interest rates. In the event interest rates rose to 7%, the counterparty to the derivative agreement would pay Fannie Mae the difference of 2% (7% - 5% representing the difference between strike and current interest rate), leaving Fannie Mae with an effective interest cost of 5%.

The cap is a series of individual options on interest rates for each quarterly or monthly period in the contract (referred to as "caplets"). An option's value is comprised of two elements, time value and intrinsic value. Intrinsic value represents the extent to which the cap is "in-the-money" based on a comparison of market interest rates to the cap's strike rate. Time value represents the remaining value attributed to the option contract by the market. Conceptually, time value can be viewed as the value attributed to the probability that the option could move further into the money during its life.

In Fannie Mae's application of hedge accounting, changes in intrinsic value are deemed to represent the "effective" portion of the hedge. This is because increases in the intrinsic value of the cap serve to offset related increases in forecasted interest payments on hedged borrowings. As such, Fannie Mae records changes in the intrinsic value component through AOCI, deferring their recognition in earnings until the future interest payments occur and affect earnings. Changes in the time value component are recorded directly to earnings as they occur.

SFAS 133 does not specify a single methodology to be used in allocating an instrument's value between time and intrinsic components. One methodology is to compare the cap strike rate to the current "spot" interest rate and derive a resulting intrinsic value for the entire cap agreement (in Fannie Mae terminology the "Trader Approach"). An alternate methodology would be to calculate the intrinsic value of each individual caplet by comparing the cap strike rate to the respective point on the forward curve (in Fannie Mae terminology the "Zero Volatility Approach"). In both approaches, the time value would represent the difference between the total fair value of the cap[308] and its calculated intrinsic value. While either method may be deemed acceptable, the two methods yield different results. Thus, one method must be

[308] The total fair value of the cap would be derived from an appropriate option pricing model.

consistently applied. For example, a cap may have zero intrinsic value under the Trader Approach because the strike rate is higher than the current market interest rate. However, in a typical upward sloping yield curve, that same cap may have some intrinsic value under the Zero Volatility Approach because the forward rates relating to the later periods of the term are higher than the strike rate.

As described above, when interest rate caps are purchased, an upfront premium is paid. To make future determinations of changes in time and intrinsic values for accounting purposes, it is necessary to allocate the initial value of the option premium between time and intrinsic value components.

Summary of Issue
Until the fourth quarter of 2002, Fannie Mae treated the entire upfront premium payment as time value because the strike rate was above the current interest rate at the time of purchase. The Enterprise used the Trader Approach to determine intrinsic value at the inception of a cap contract. However, for subsequent calculations at each reporting date, Fannie Mae calculated intrinsic value using the Zero Volatility Approach. As a result, during the time from adoption of SFAS 133 (January 2001) through the third quarter of 2002, **Fannie Mae was applying an inconsistent methodology in its determination of time and intrinsic value.** Because many of the caps purchased by Fannie Mae had intrinsic value at the time of purchase under the Zero Volatility Approach, yet had no intrinsic value at inception under the Trader Approach, this inconsistent methodology resulted in misstatements of changes in time value and intrinsic value reported in earnings and AOCI, respectively.

The misstatement that occurs when this inconsistent methodology is applied can be illustrated by the following simple example. Assume an interest rate cap is purchased for $1,000,000 and its value is further broken down as follows under the two approaches:

	Trader Approach	**Zero Volatility Approach**
Time Value	$1,000,000	$ 500,000
Intrinsic Value	0	500,000
Total Value at inception	1,000,000	1,000,000

In addition, assume that the above options were purchased near quarter-end and that as of the quarter-end reporting date, there had been no change in interest rates or in the total fair value of the cap contract. Under either approach, if applied consistently, there would be zero change in the option time value or intrinsic value, and no gain or loss recorded through earnings or AOCI.

However, when the inconsistent approach applied by Fannie Mae is used at the quarter-end reporting period, the following result would be reflected:

	Time Value	**Intrinsic Value**
Ending Value – Zero Volatility Approach	$ 500,000	$ 500,000
Beginning Value – Trader Approach	1,000,000	0
Change in Value	(500,000)	500,000

As a result, Fannie Mae would have recorded a loss in earnings for change in time value of $500,000 and a gain in AOCI for change in intrinsic value of the same amount, when in fact there was no change in the instrument's value. Furthermore, because no change in interest rates had occurred, there would have been no change in the forecasted interest payments that were being hedged by the caps. As such there would be no basis under SFAS 133 to record a gain in AOCI as there had been no corresponding change in the underlying hedged item. OFHEO has determined that the above accounting for the cap represents an error in the application of SFAS 133.

As a result of using the Trader Approach at inception and the Zero Volatility Approach on subsequent reporting dates, Fannie Mae was overstating its option premium expense as well as gains recorded in AOCI due to changes in intrinsic value. It appears that the largest impact of this treatment would have been in the quarter in which a cap contract is executed, due to the immediate premium expense and AOCI gain that would be recognized relating to the inception intrinsic value. There would also be an effect on earnings in periods later in the life of the cap contracts (to which the original intrinsic value relates), as the inception intrinsic value gains are reclassified into earnings as payments are made on the cap.

In the fourth quarter of 2002, Fannie Mae changed its accounting for the premium paid at inception for interest rate caps.[309] Effective October 1, 2002, Fannie Mae began to allocate the initial premium paid to both time value and intrinsic value, using the Zero Volatility Method. This change was implemented prospectively, that is for new caps purchased after September 30, 2002.[310] Fannie Mae concluded in an internal memorandum addressing this issue that they believed that this change qualified as a change in accounting analogous to that described in paragraphs 23 and 24 of APB 20.[311]

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[309] Fannie Mae December 31, 2002 annual report on form 10-K, Notes to Financial Statements, Significant Accounting Policies, p. 113.

[310] Information has been obtained from the following sources:

1. Fannie Mae December 31, 2002 annual report on form 10-K, Notes to Financial Statements, Significant Accounting Policies, p. 113.
2. Memorandum from Jonathan Boyles to File with Distribution, Subject: Proposal to Change Fair Value Estimate of IV/TV Decompositions for Caps, January 29, 2003, FMSE 055014-055016.
3. OFHEO interview, Jonathan Boyles, Senior Vice President—Financial Accounting Standards and Corporate Tax, August 24, 2004, pp. 211, 214

Q: [...]it was being treated prospectively. You didn't go back and correct some of the, your prior periods?

A: We didn't feel there was a need to correct because we deemed it to be a change in estimate, so we refined our estimation process. Now our describe that in our disclosures[...]

Q: [...]when talking about the effect of th [sic] change in running an analysis, did anyone go and perform analysis what would be the impact on the quarterly basis had the consistent estimation methodology been used throughout the life of an option?

A: I don't recall. I believe there was a lot of analysis done at the time[...]

[311] Memorandum from Jonathan Boyles to File with Distribution, Subject: Proposal to Change Fair Value Estimate of IV/TV Decompositions for Caps, January 29, 2003, FMSE 055014-055016, in which Mr. Boyles stated, "In addition, even though we think this change should be analogized to paragraphs 23 and 24 of APB-20, if one were to conclude that this is a change in estimate the accounting treatment would be the same."

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It is OFHEO's belief that the accounting change made by Fannie Mae is correcting an inconsistent application of a methodology and not a change in methodology to calculate fair values and therefore should be treated as a correction of an error. As illustrated in the example above, the inconsistent application results in a misstatement of amounts recorded in both AOCI and earnings. A correction of an error would require the prior period financial statements to be restated.

Accounting Analysis
APB 20's scope includes changes in accounting principles, accounting estimates, or reporting entity. It also covers reporting of a correction of an error in previously issued financial statements.

Is it a Change in Accounting Principle?
Paragraph 7 of APB 20 states that a change in accounting principle "results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes." This statement includes not only accounting principles and practices but also the methods of applying them, or when choosing from among two or more generally accepted accounting principles, such as two amortization/depreciation methods, alternative methods of revenue recognition under long-term contracts, or alternative inventory pricing methods.

The above change did not entail a choice of a new generally accepted accounting principle different from the one previously applied. Rather, it represented a change to correct an inconsistency in prior application. It therefore **should not be considered a change in accounting principle.**

Is it a Change in Accounting Estimate?
A change in accounting estimate is due to the occurrence of new events, as more experience is acquired, or as additional information is obtained. Paragraph 11 of APB 20 highlights a change in estimate affected by a change in accounting principle. "Changes of this type are often related to the continuing process of obtaining additional information and revising estimates and are therefore considered as changes in estimates for purposes of applying this Opinion."

The change in the way Fannie Mae used to account for the premium at inception did not result from the occurrence of new events or as more experience was acquired or as additional information was obtained. It was based upon an apparent realization that the prior methodology was causing incorrect financial statement results. It therefore **cannot be considered a change in estimate.**

Is it an Error in Financial Statements?
Paragraph 13 of APB 20 states "Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment."

In OFHEO's view, Fannie Mae's change in methodology resulted from a previous oversight or an inconsistent application of accounting principles. Fannie Mae's old methodology resulted in amounts recorded in AOCI when no corresponding change had occurred in the forecasted hedged item, which is clearly inconsistent with the cash flow hedge accounting provisions of SFAS 133. The offset to the error in AOCI is a misstatement in option premium expense. Therefore, the above change should have been **treated as a correction of an error**, resulting in the correction and re-statement of prior periods' financial statements.

Fannie Mae's interpretation of the relevance of APB 20

Fannie Mae treated the above change to be similar to that of a change in a method of amortization as discussed under paragraph 23 of APB 20. They accounted for the change in accordance with the guidance in paragraph 24 of APB 20, which relates to a new method of amortization applied to newly acquired assets. Paragraph 24 states that the Enterprise should use the new method "for all additional new assets of the same class but continue to use the previous method for existing balances of previously recorded assets of that class. For that type of change in accounting principle, there is no adjustment of the type outlined in paragraphs 19-22[312], but a description of the nature of the change in method and its effect on income before extraordinary items and net income of the period of the change, together with the related per share amounts, should be disclosed."

The excerpt below from Fannie Mae's 2002 10-K sets forth Fannie Mae's disclosure of the change in methodology.

> During the fourth quarter of 2002, we refined our methodology for estimating the initial time value of interest rate caps at the date of purchase and prospectively adopted a preferred method that resulted in a $282 million pre-tax reduction in purchased options expense and increased our diluted EPS for 2002 by $.18. Under our previous valuation method, we treated the entire premium paid on purchased "at-the-money" caps as time value with no allocation to intrinsic value. Our new methodology allocates the initial purchase price to reflect the value of individual caplets, some of which are above the strike rate of the cap, which results in a higher intrinsic value and corresponding lower time value at the date of purchase. This approach is more consistent with our estimation of time value subsequent to the initial purchase date. This change does not affect the total expense that will be recorded in our income statement over the life of our caps and has no effect on our non-GAAP core business earnings measure.

[312] These paragraphs discuss the recording of a cumulative effect of a change in accounting principle, the disclosure of pro-forma effects of retroactive application, and a change in depreciation method for previously recorded assets.

Reporting a Correction of an Error
Reporting a correction of an error in the financial statements of a prior period discovered subsequent to their issuance should be reported as a prior period adjustment (paragraph 36 of APB 20). In addition, APB 9, *Reporting the Results of Operations*, states "when comparative statements are presented, corresponding adjustments should be made of the amounts of net income (and the components thereof) and retained earnings balances (as well as of other affected balances) for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments."

Implications
The implications of treating the above change prospectively as a change in accounting rather than a correction of an error is that the earnings and OCI amounts have been misstated for the years 2001, 2002 and likely for 2003 and possibly later periods depending upon the original maturity of the cap contracts and the future periods to which the inception intrinsic value relates.

The table below has been extracted from a memorandum from Jonathan Boyles and provides some indication of the potential dollar impact.[313] However, OFHEO contends it does not provide one with an accurate measure of the quarterly impact on earnings or AOCI.

		New Methodology		Old Methodology	
Purchase Period	Purchase Premium*	Intrinsic Value*	Time Value*	Intrinsic Value*	Time Value*
2001	248.0	128.7	119.3	0	248.0
2002	1055.0	544.0	511.0	0	1055.0
*2002: Q4***	489.7	257.8	231.8	0	489.7

* *All figures in millions of dollars*
** *The New methodology was first implemented in Q4, 2002.*

Using the 2002 information presented above for discussion purposes, it appears that options were purchased prior to the fourth quarter for an initial premium of $565.3 million ($1,055 million less $489.7 million).[314] Based on the amounts listed under the column titled New Methodology, approximately $286.2 million ($544 million - $257.8 million) should have been recorded as intrinsic value and $279.2 million ($511 million - $231.8 million) should have been recorded as time value during the first three quarters of 2002. This means that when applying the Old Methodology, option premium expense was overstated by $286.2 million in the quarters when these options were purchased, and accumulated AOCI gains/losses were overstated/understated by the same amount. Interest expense would also be understated in the future periods to which the inception intrinsic value relates. The specific periods affected would need to be determined based upon the terms of the individual cap contracts.

[313] Memorandum from Jonathan Boyles to File with Distribution, Subject: Proposal to Change Fair Value Estimate of IV/TV Decompositions for Caps, January 29, 2003, FMSE 055014-055016. The table is on page 3 of the document (FMSE 055016).
[314] As stated in the table, the new methodology was implemented starting in the fourth quarter of 2002.

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Additionally, Fannie Mae's 10-K describes the change as a prospective change to a "preferred method" [315] of accounting. However, in a memorandum written by Jonathan Boyles in 2003,[316] he refers to the matter as an inconsistency in approaches. Mr. Boyles reference to the inconsistencies in the memorandum has not been disclosed in the 10-K. In fact, the disclosure discusses a refinement in methodology[317] and makes no reference to the inconsistent application of methods, which OFHEO believes represents an accounting error.

The above analysis and discussion show that Fannie Mae has incorrectly accounted for and reported a correction of an error in its financial statements. This is yet another example of how Fannie Mae has corrected errors in their accounting for derivatives only on a prospective basis. The impact on specific periods is unclear. Further detailed information and detailed instrument-by-instrument analysis will be required to make a precise determination of the complete financial statement impact on all periods affected.

[315] Fannie Mae December 31, 2002 annual report on form 10-K, Notes to Financial Statements, Summary of Significant Accounting Policies, Derivative Instruments and Hedging Activities, p. 113.
[316] Memorandum from Jonathan Boyles to File with Distribution, Subject: Proposal to Change Fair Value Estimate of IV/TV Decompositions for Caps, January 29, 2003, FMSE 055014-055016, in which Mr. Boyles stated, "As the dollar amount of our cap purchases has grown over time, this inconsistency in approaches has led to growing differences in our decomposition of IV/TV."
[317] Fannie Mae December 31, 2002 annual report on form 10-K, Notes to Financial Statements, Summary of Significant Accounting Policies, p. 113, states, "During the fourth quarter of 2002, we refined our methodology for estimating the initial time value of interest rate caps at the date of purchase and prospectively adopted a preferred method that resulted in a $282 million pre-tax reduction in purchased options expense and increased our diluted earnings per share for 2002 by $.18."

Issue 5: Hedge Accounting Documentation Issues

The importance of designation, documentation and risk management is emphasized by the FASB in the basis for conclusions of SFAS 133. Paragraph 385 states:

> The Board decided that concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result. The Board also decided that identifying the nature of the risk being hedged and using a hedging derivative consistent with an entity's established policy for risk management are essential components of risk management and are necessary to add verifiability to the hedge accounting model.

The designation and documentation requirements were acknowledged by Franklin Raines in "Answers from the CEO,"[318] in which he stated:

> The hedge accounting treatment for each individual transaction is determined -- and documented in writing -- before we enter into the transaction. And it cannot subsequently be changed.
>
> —*Franklin Raines, Answers from the CEO*

Background
SFAS 133, paragraphs 20(a) and 28(a) for fair value and cash flow hedges respectively, require an entity to document at inception of the hedge the following:

(1) management objective and strategy for entering into the hedge;
(2) identification of the hedging instrument;
(3) the risk being hedged; and
(4) how hedge effectiveness will be assessed.

In addition to the above criteria, paragraph 28(a) (2) of SFAS 133, which applies to cash flow hedges, goes on to state that the level of detail that must be documented at the inception of the hedge regarding identification of the forecasted transaction must be "with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction."

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[318] Fannie Mae website, Answers from the CEO. Fannie Mae describes this section of its website as follows, "This section of our Web site is designed to help visitors better understand the company's approach to the issues we face. As part of our continuing effort to be best-in-class in corporate governance and transparency, Chairman and Chief Executive Officer Franklin D. Raines is committed to answering investors' most frequent questions about Fannie Mae's business. This section provides plain talk about how we operate to provide liquidity to the homeownership markets." The answer shown is in response to the following question, "Why do you have confidence that you have done your derivatives accounting properly?"
http://www.fanniemae.com/ceoanswers/derivativesaccounting.jhtml

Fannie Mae's documentation of a hedge relationship in support of hedge accounting for transactions entered into by the Long Term Funding Desk includes the following:[319]

- Termsheets describing the hedging instrument and the hedged item
- The linkage of the derivative with the hedged item (as reflected in the "DEBTS" system)
- The transaction descriptions for permitted hedging strategies in the DAG

Termsheets are produced at the time a derivative is entered into the system. The termsheets identify if the hedge relationship qualifies for hedge accounting. Additionally, when the derivative qualifies for hedge accounting, the termsheet identifies the hedged item, the hedging relationship, the type of hedge and how effectiveness will be measured. The DAG indicates that the termsheet forms the initial hedge designation documentation for derivatives entered into by the Long-term Funding Desk. The linkage in the DEBTS system associates the derivative with the hedged item. The transaction descriptions in the DAG attempts to include all potential hedging strategies that Fannie Mae may enter into and describes the accounting that should be followed for each such strategy.

Katarina Skladony, a Senior Financial Analyst in Fannie Mae's Treasury Middle Office, is responsible for ensuring that the derivatives and hedged item are properly linked to a hedged item within DEBTS. The termsheets, which are generated once the derivative is entered into and verified by the back office, serve as the initial documentation of the hedge relationship.[320] OFHEO understands there is no reconciliation performed between the termsheet and the ultimate hedge linkage in DEBTS. Ms. Skladony also indicated that the final determination of the nature of the hedging relationship (fair value or cash flow) and the hedged item is made by the Controller's Financial Accounting group and not by Treasury Middle Office.[321] The ability for

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[319] OFHEO interview, Jonathan Boyles, Senior Vice President of Accounting Standards and Corporate Tax, August 24, 2004, p. 138, where he stated that: "We have viewed, for our documentation, we have viewed a combination of termsheets, our accounting policy manual, and the transcription in our systems linkages in combination as all of the documentation, so you can look at those, and you'll see what the linked items are, you'll see what the accounting is, you'll see if the risk is being hedged, you'll see the terms matching pieces in there."

[320] OFHEO interview, Katarina Skladony, Senior Financial Analyst – Treasury Middle Office, August 26, 2004, p.10, where she stated that, "[...]the back office verifies the securities and produces the initial term sheet that includes the hedge designation. The back office then distributes this documentation to the Controllers[...].

[321] OFHEO interview, Katarina Skladony, Senior Financial Analyst – Treasury Middle Office, August 26, 2004, pp. 78-79

Q: ...Is that the normal process that Controllers make the decision whether it's a cash flow hedge or a fair value hedge?

A: Correct.

Q: In all instances?

A: Correct.

Q: And how often do they do that?

A: They do it on monthly basis when we pass them on, all the relinkage files. [...]

Q: Up until when Controllers make that determination that it's a cash flow hedge or a fair value hedge, is there no determination whether it's a cash flow hedge or a fair value hedge?

A: When the dynamic links are created, the determination is not made what type of hedge it is. That is determined by Controllers FAS 133 system from when that information is passed to that system. [...]

Q: Does Controllers also make the determination that the trade is DNQ?

A: Correct.

Accounting to change the ultimate treatment of a hedge's designation is not consistent with the standard's requirements for concurrent designation and documentation noted above.

The Financial Accounting Group is the business owner of the FAS 133 (accounting) system and is responsible for recording accounting entries relating to the system. Ms. Mona Patel, Senior Project Manager – Financial Accounting Group, indicated that the FAS 133 system receives information from DEBTS on a daily basis. A program is run in the FAS 133 system at the end of the month to determine the hedge classification (cash flow hedge or fair value hedge) based on the terms of the derivatives received from DEBTS. There is no reconciliation between the hedge classification as determined on the term sheet and that in the FAS 133 system.

If there is a change in linkage in DEBTS, the hedge classification may change. Based on the interview with Ms. Patel, if the hedge classification changes for a particular derivative from the prior month, the FAS 133 system assumes that the change in hedge classification is effective from the start of the month even though the linkage may have changed on the last day of the month.[322] As part of the month-end FAS 133 accounting process and prior to posting of journal entries, the Financial Accounting Group runs an exception report which identifies all derivatives that do not qualify for hedge accounting. This report is sent to Treasury who will review the report and evaluate whether any changes should be made to the linkages. Treasury advises the Financial Accounting Group of changes to linkages as a result of those derivatives that are on the exception list which may qualify for hedge accounting. These retroactive changes in linkages are inconsistent with the contemporaneous documentation requirements of SFAS 133.

Summary of Issues

There are several instances where OFHEO believes the hedge documentation is inadequate and does not meet requirements of SFAS 133 to qualify for hedge accounting. The inadequacies are categorized as follows:

- Ambiguity of hedging relationship
- Hedged risk not properly defined
- Hedged item not specifically identified in certain fair value hedges
- No termsheet produced for re-linkages
- Designation not contemporaneous
- Unclear definition and probability of hedged transaction in cash flow hedges
- Retroactive linkage of hedging instruments with hedged items

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[322] OFHEO interview, Mona Patel, Senior Project Manager – Financial Accounting Group, September 8, 2004, pp. 52-53

Q: So, what would be the entry that you would pose [sic] for the entire month?

A: Okay. The system would pose [sic] prior month as a cash flow hedge, so it would book the market value over to either a gain or a loss on the balance sheet as derivatives in a gain or a loss, and the offset would be to OCI, other comprehensive income. Next month, that swap is a fair value hedge so the system would report again the derivatives in a gain or loss, and it would also record--it would also adjust the debt basis. So, the derivatives would be recorded as a gain or loss and offset to the P&L, and you would also adjust your debt basis offset to the P&L.

Q: So, would it be for the entire change in fair value from the first of the month of the month through June 30th in the swap value and in the debt or the hedged item value debt for the entire month, even though the link changed only mid-month.

A: Yes.

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Ambiguity of hedging relationship
In our review of termsheets generated by DEBTS we noted that certain termsheets contained ambiguous hedge designation language. For instance, in some cases the term sheet designates the same derivative as both a cash flow and a fair value hedge. An example of this is in a term-out transaction similar to the one described under Issue 2: Derivative Re-Designations.[323] In such situations, OFHEO noted term sheets that described a debt swap[324] as a fair value hedge of the MTN issued at the beginning of period B, and also a cash flow hedge (in combination with swap #1) of the forecasted issuance of DN's in period C. Such a dual designation is not permitted under SFAS 133, which requires specific identification of the hedged item at the inception of the hedging relationship.

OFHEO understands that the linkage between the hedged item and the hedging instrument in the DEBTS system is done through an automated process whereby the system "finds" a combination of derivatives and debt instruments that can be linked together in a hedging relationship. In the term-out example, the ambiguous documentation would allow DEBTS to assign the debt swap to either a fair value or a cash flow hedge relationship and still appear to be consistent with the hedge designation on the term sheet. It also appears that this ambiguous designation approach would allow linkages between derivatives and hedged items to be changed after the fact and still appear to be "consistent" with the original designation documentation.

Hedged risk is not accurately defined
In instances involving option products, OFHEO has noted the hedge documentation does not appropriately identify the hedged risk. For example, as discussed earlier in relation to hedges using receive-fixed swaptions, the termsheets describe the strategy as one that synthetically converts fixed rate debt to floating, and the hedged risk as changes in fair value of the debt attributable to the benchmark interest rate. However in reality, Fannie Mae is only protected against changes in fair value due to a decline in interest rates below a certain level, and the fixed rate debt is only synthetically converted to floating rate if and when the swaption is exercised. In these cases, the documentation fails to properly identify the hedged risk as required to receive hedge accounting under SFAS 133. Similar deficiencies in documentation of the hedged risk exist for strategies involving pay-fixed swaptions and callable swaps

Hedged item not specifically identified in certain fair value hedges
OFHEO also noted that when Fannie Mae uses receive-fixed swaptions in fair value hedges of fixed rate debt, its policy is not to identify the debt instrument being hedged until the option becomes "in-the-money." This approach is not consistent with the requirement in paragraph 21(a) of SFAS 133 that the hedged item be "specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment." It also appears inconsistent with Fannie Mae's assertion of perfect effectiveness for such transactions, since it is impossible to make such a determination without identifying the terms of the hedged item.

[323] Referred to as "Term-out transaction #2" in the DAG. FMSE 112990-112991.
[324] For purposes of this report, a debt swap is defined as a receive-fixed swap.

Absence of termsheets for re-linkage
Fannie Mae regularly "re-links" its derivatives and hedged items, which often represents the designation of a new hedge relationship prospectively under SFAS 133. When derivatives are re-linked in this manner there is no termsheet created to document the new hedge relationship that has been established. Since re-linking derivatives is a recurring practice at Fannie Mae, and the DAG indicates that termsheets serve as a primary hedge designation document, OFHEO believes that a significant number of hedge relationships may not have the appropriate documentation to qualify for hedge accounting under SFAS 133.

Designation not contemporaneous
As mentioned above, it appears that the final determination of the hedge relationship is made by the Controller's Department upon review of information populated in the SFAS 133 system from DEBTS. This information is updated approximately monthly. This seems to indicate that the hedge relationship is not final and is potentially subject to change until reviewed by the Controllers group. This would appear to be inconsistent with the contemporaneous designation requirements of SFAS 133. Additionally, no termsheets are produced at the time of relinkage and the only hedge documentation that is available is the linkage in the DEBTS system. The absence of a termsheet could allow Fannie Mae to make retroactive changes to the linkages in DEBTS without any audit trail of changes.

Additionally, Fannie Mae's DAG and operating practices allow them seven days to identify and document the hedged item. This practice is inconsistent with the requirements of contemporaneous hedge documentation. To illustrate the practices followed by Fannie Mae, the following is an excerpt from an email from Paul Salfi, Director of the Financial Standards Group, to Jonathan Boyles discussing the fact that Fannie Mae has seven days to document a hedge relationship.[325] It states the following:

> We have a situation where Treasurer's wants to override automated linkages of DNQ basis swaps to PF swaps to avoid long haul on the combination. Instead, they want to keep the basis swaps DNQ and the PF swaps with termouts such that the combination is perfectly effective. The questions are when is the effective date of the original linkages of basis swaps and PF swaps and do we give them a grace period of 7 days to correct the error.
>
> Below are my thoughts on what the guidance should be that I wanted to run by you:
>
> Since my understanding is that our policy has been to link derivatives within 7 days of settlement to attempt to get hedge accounting for the derivative, we have seven days from the reset dates of the PF swaps to correct the error made by DEBTS. My understanding is that DEBTS linked basis swaps that

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[325] Email from Paul Salfi to Jonathan Boyles, copy to Ilan Sussan, Subject: Re: 315SWD441_linkage_analysis.xls – Please approve link changes, April 21, 2004, produced via CD 8/11/04 in Box M. This email is the 3rd in a chain of emails. The most recent email (on top) is an email from Paul Salfi to Jonathan Boyles, April 22, 2004, subject: same as above.

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were DNQ to PF swaps effective on the PF reset dates below, but that we did not want this linkage.

If we correct the linkages within 7 days of the PF reset dates below, we would honor the new designations not the ones on 4/12 to be effective beginning on the PF reset dates below. The PF swaps had adequate funding through the PF reset dates below, so the PF reset dates below are considered to be the effective date of the original designations as this the beginning point from which the PF swaps needed to get hedge accounting. The basis swaps would be DNQ under the new designations.

Unclear definition and probability of hedged transaction in cash flow hedges
A number of Fannie Mae's hedging strategies represent cash flow hedges relating to interest rate risk associated with existing and forecasted issuance of DNs. In many situations, DNs are subsequently replaced ("termed-out") with other forms of borrowings, such as fixed or floating rate MTNs. Fannie Mae's DAG contemplates the occurrence of term-outs by virtue of the transaction descriptions contained therein, many of which are examples of various forms of term-outs. When a term-out occurs, Fannie Mae's practice is to continue to retain any accumulated hedge gains or losses in AOCI because future interest payments are still expected to occur.[326] The nature of Fannie Mae's funding and hedging strategy and in particular the regular occurrence of term-outs have certain implications regarding hedge accounting under SFAS 133, namely:

- How the hedged transaction has been defined in the designation documentation -- specifically whether such designation is made "broadly" to encompass interest payments generally on a portfolio that consists of DNs as well as instruments that may subsequently replace them, or whether the designation is "specific" to DNs only;
- Whether the hedged transaction (as defined) is deemed probable of occurring which is a requirement to qualify for cash flow hedge accounting both at inception and on an ongoing basis; and
- Whether a term-out or similar transaction indicates that the hedged transaction (as defined) is deemed "probable of not occurring" which would mean that: a) any amounts accumulated in AOCI should be reclassified into earnings; and b) the ability to apply hedge accounting to similar hedge relationships would be called into question.

The implications of these issues are summarized in the following endnote excerpt from DIG Issue G13 *Cash Flow Hedges: Hedging the Variable Interest Payments on a Group of Floating-Rate Interest-Bearing Loans ("DIG Issue G13"):*

> How the hedged forecasted transaction is designated and documented in a cash flow hedge is critically important in determining whether it is probable that the hedged forecasted transaction will occur. In the cash flow hedge in Example 8, **had the hedged forecasted transaction been narrowly**

[326] Even though the DNs are no longer issued, they have been replaced with another interest-bearing debt instrument. This treatment is pursuant to Example 8, Scenario 2 in SFAS 133, and in particular, paragraph 160.

> **limited to the interest payments on specific future debt issuances rather than on the five-year borrowing program** [Emphasis added], the failure to engage in those future debt issuances would cause the related derivative net gain or loss in OCI to be immediately reclassified into earnings pursuant to paragraph 33 because it would have been probable that the hedged forecasted transactions would not occur. Furthermore, that failure, if part of a pattern of having hedged forecasted transactions cease being probable of occurring, would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions, pursuant to paragraph 494.

The accounting treatment applied by Fannie Mae, as well as the transaction examples documented as part of its DAG, appear to imply an approach of "broad" designation to future interest payments, rather than a specific or narrow designation to interest on DNs only. However, OFHEO has observed the following elements of Fannie Mae's hedge accounting documentation and approach that appear to be inconsistent with an approach of broad designation:

- Term sheets representing the inception hedge designation documentation refer specifically to DNs and ***not*** a broad designation to include interest payments on other borrowings, such as MTNs, resulting from a term-out.
- Within DEBTS, derivatives are "linked" to ***specific*** DNs for purposes of designating the relationship and matching of terms (and in most cases, for asserting perfect effectiveness). This is ***inconsistent*** with a broad designation scheme. OFHEO understands that when broad designation approaches are used for hedging of short-term borrowings, standard industry practice is that matched terms or "short-cut" like approaches are not used. Instead, effectiveness is assessed and measured based on the derivatives' relationship with the reset and other characteristics of the entire portfolio (or portion thereof being hedged) and not based on specific debt instruments.

This ambiguity in Fannie Mae's documentation has serious implications for its cash flow hedge accounting associated with DNs. If the assertion is made that a narrow designation scheme is being used, the occurrence of term-outs would require that amounts accumulated in AOCI be reclassified to earnings when the term-out occurs, and would call into question the ability to apply cash flow hedge accounting to such transactions in the future due to the frequency of term-outs. Conversely, if the assertion is made that a broad designation scheme is used, the treatment of hedges as perfectly effective based on matching to specific DN issuances would be invalid and would disqualify hedge accounting due to the lack of an appropriate assessment of effectiveness.

Furthermore, Fannie Mae's DAG and related documentation do not appear to explicitly address the matter of probability of forecasted transactions (irrespective of whether they have been defined in a broad or specific manner). Because forecasted transactions must be deemed probable to qualify for cash flow hedge accounting, an analysis should be performed and periodically updated to support this assertion, based on factors such as business plans, forecasted growth of the mortgage and debt portfolios, sources of future funding, etc. Based on

the information obtained and reviewed by OFHEO, it is unclear how Fannie Mae has addressed this requirement.

Retroactive linkage of hedging instruments with hedged items
Through the special examination of Fannie Mae, OFHEO has noted instances in which Fannie Mae has retroactively re-linked a hedging instrument to a hedged item in order to qualify for special hedged accounting treatment. Retroactive re-linkage to obtain special hedge accounting is not permitted by SFAS 133. The retroactive linkages appear to have occurred for several reasons including:

- re-linking a derivative to a different hedged item due to a failed correlation analysis with the original hedged item,
- re-linking a derivative to an eligible hedged item due to an erroneous system linkage to an ineligible hedged item, and
- re-linking a derivative to a different hedged item at the request of the front office in order to achieve the trader's original intent.

In the March 31, 2003 Derivatives Controls Audit, the Fannie Mae Office of Audit conclusion recommended that the controls over the re-linkage of derivatives to debt and other derivatives needed to be clarified.[327] In the report it stated:

> This may occur when the hedged debt is called or when a derivative is termed-out. We noted that procedures for re-linking derivatives are not well documented, and review and approvals are not robust.
>
> Specifically, we noted that the Hedge Accounting guidelines do not address the process for linkages and type [sic] types of re-linkages allowed. We noted one instance in which a derivative was re-linked to a debt instrument retroactively to reduce the amount of hedge ineffectiveness at month end. Although the financial statement impact was minimal, retroactive re-linkages do not conform to FAS 133 requirements.

As a response, a memorandum was drafted in October of 2003 by the Financial Accounting Standards group outlining Fannie Mae's procedures with respect to the manual re-linking of term-outs.[328] However, the memorandum did not address retroactive linkages or re-linkages. In an interview with Katarina Skladony in which retroactive re-linkages were addressed, the witnesses testified that situations in which retroactive re-linkages were made were rare[329]. The

[327] Derivatives Controls Audit Report, Office of Auditing, March 31, 2003, Paul Jackson, Audit Director, FMSE 102385-102391.
[328] Memorandum written by Paul Salfi to File with Distribution, Subject: Manual ReLinking of Termouts: Procedures, Documentation, and Examples, October 15, 2003, FMSE 027422-027426.
[329] OFHEO interview, Katarina Skladony, Senior Financial Analysis-Treasury Middle Office, August 26, 2004, p 23
A: In this case, a trader asked me to find out whether such an option even exists. It's not a standard rule that in all the circumstances we always go and make change for the system. We determine, you know, whether such a change is appropriate in the first place, and if it's not appropriate, then we don't make a change.
Q: How often does something this happen?
A: It does not happen often. I think that this would be a fairly rare situation.

following emails were identified by OFHEO during its examination, of instances in which retroactive re-linkages have occurred at Fannie Mae.

In an email dated 1/6/2004 from Katarina Skladony to Mona Patel and copying several individuals in Treasury Middle Office, Front Office and Financial Reporting, Ms. Skladony makes a retroactive re-linkage per the request of a trader from the front office.[330] The email states:

> Enclosed spreadsheet shows the proposed linkage changes in order to bring the termout linkages in line the [sic] trader's intent at the time of buyback. I highlighted in yellow the linkages that need to be reversed and restored. In addition, I typed in blue all additional linkages that need to be broken.

In the same chain of emails, a message on the same day from Linda Knight to several individuals including Laura Simmons, Donald Sinclair and Katarina Skladony, Ms. Knight stated:[331]

> I just spoke to Janet Pennewell who confirmed the guidance from yesterday. Controllers just finished meeting with Peat who concurs with this guidance. We can go ahead and change linkages to the traders intent at the time of the buyback. That means we can establish the links that were intended from Don Sinclair's spreadsheet on 12/16...Finally, Peat confirmed that we cannot change the spreadsheet so we cannot adjust anything related to spreadsheet mistakes...

The excerpt above illustrates that Fannie Mae had treated the front office documentation created by Donald Sinclair (the spreadsheet referred above) as hedge designation documentation in an effort to correct an accounting linkage error. As mentioned earlier, per Jonathan Boyles, Fannie Mae's hedge designation documentation consists of "a combination of termsheets, our accounting policy manual, and the transcription in our systems linkages...".[332]

Also as noted earlier, termsheets are not prepared for documentation of re-linkages and there is no other formally established means for hedge designation upon a re-linkage. This makes a retroactive re-linkage such as the one described above questionable since there is no formal document that can be referred to as the proper source of hedge designation. Instead, Fannie Mae made the designation based on a spreadsheet that was represented as the "trader's intent." Had there been a termsheet in place to establish the re-linkage, such document would presumably have represented the trader's intent and there would be no question about the proper course of action. Absent a formal document used for designation of the hedge relationship upon a re-linkage, the ability exists to retroactively change designations in order to

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[330] Email from Katarina Skladony to Laura Simmons, Donald Sinclair with a copy to Mona Patel, January 6, 2004, Subject: Corrected Termout Linkages due to 12/18/03 Buyback – PLS APPROVE, produced via CD 8/11/04 in M box.

[331] Email from Linda Knight to Laura Simmons, David Benson, Donald Sinclair, Ursula Schaefer, Nadine Bates, Katarina Skladony; Copes to Janet Pennewell and Peter Niculescu, January 1, 2004, Subject: Buybacks, produced via CD 8/11/04 in M box.

[332] OFHEO interview, Jonathan Boyles, Senior Vice President – Financial Standards and Corporate Tax, August 24, 2004, p.138.

achieve a desired accounting result. This is not permitted under SFAS 133. Paragraph 385 of SFAS 133 states:

> The Board decided that concurrent designation and documentation of a hedge is critical; without it, **an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result**... [Emphasis added.]

In a 2001 email from Katarina Skladony to Mona Patel, Ms. Skladony stated:

> Please note that I am going to make the below manual change in linkage for 313SWI540. The 50M link 313SWI540 – 313SWD758 was qualified for long haul method. However, in the process of effectiveness calculation Don had a problem to reach 80-120% correlation range and asked me to seek alternative linkage to 313SWI540. I found 313SWD979 reset determination dates of which and 313SWI540 meet the 7 day window requirement and thus qualify for the short cut method."[333]

This above excerpt illustrates that retroactive re-linking was being applied to hedges in order to achieve hedge accounting treatment in situations in which the hedge effectiveness criteria (through a correlation analysis) was not met. This is clearly an example of retroactive designation in order to achieve a desired accounting result and is not permitted under SFAS 133 per the reference above.

Implications

The numerous documentation issues described above appear to have serious implications for Fannie Mae's hedge accounting. Many of these matters relate to routine, commonly occurring transactions at Fannie Mae. Under SFAS 133, the lack of adequate, contemporaneous hedge designation documentation precludes a company from qualifying for hedge accounting. This has been reiterated by the SEC staff.[334] Failure to receive hedge accounting means the fair value changes for such derivatives should be recorded through the income statement without receiving any offset, or matching with, the earnings affect of the hedged item. Given the billions of dollars of mark-to-market value of Fannie Mae's derivatives and the fact that the vast majority of them are currently receiving hedge accounting, the potential impact of these documentation issues on Fannie Mae's reported financial results and regulatory capital appears to be substantial.

[333] Email from Katarina Skladony to Mona Patel and Prasad Chintamaneni with a copy to Donald Sinclair, March 5, 2001, Subject: 313SWI540 switch from long haul to short cut, FMSE 100488-100490.

[334] See reference to December 2003 speech of John James in background section of this report.

ACCOUNTING OVERSIGHT

As part of the special examination of Fannie Mae, OFHEO reviewed the following four aspects of the Enterprise's financial reporting practices: (1) accounting policy development, (2) accounting policy review, (3) segregation of duties and (4) key person dependency. OFHEO concentrated examination efforts on evaluating the roles and responsibilities of the executives in the Controller's Department and the related controls that support the integrity of the financial reporting process. OFHEO believes that a lack of proper segregation of duties exists within Fannie Mae's Controller's Department which has created an environment that is not conducive for developing safe and sound financial reporting practices. AICPA Statement on Auditing Standards 1 (SAS 1) offers the following guidance on the responsibility of management for adopting sound accounting policies:

> Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly, the fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. The independent auditor may make suggestions as to the form or content of financial statements or he may draft them in whole or in part, based on management's accounts and records. However, his responsibility for the statements he has examined confined to the expression of his opinion on them. The financial statements remain the representations of management.[335]

Fannie Mae, accounting policy recommendations are the responsibility of Jonathan Boyles. During testimony, Tim Howard explained that the accounting policy development process is such that the SVP for Financial Standards has the authority to recommend a specific policy, the Controller has the responsibility and authority for approving accounting policy, and the CFO has the general responsibility for the adopted accounting policies.[336] Based on evidence reviewed during the Special Examination, OFHEO believes that the accounting policy development process within the Controller's Department lends itself to the formation of accounting policies that are aggressive in nature and which do not comport with a strict interpretation of GAAP as promulgated by the Financial Accounting Standards Board (FASB).

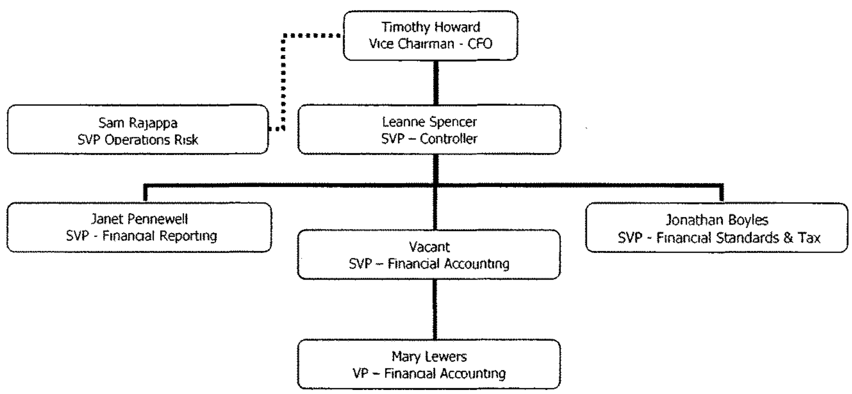
In addition, OFHEO identified critical resource shortages and a lack of technical accounting expertise within the Controller's Department which resulted in key person dependencies.

[335] American Institute of Certified Public Accountants (AICPA) 2002 *Codification of Auditing Standards and Procedures*, Statement of Auditing Standards No. 1, Section 110.02. New York, NY: AICPA.
[336] OFHEO Interview, Mr. Tim Howard, August 5, 2004, p. 21
Q: Who has the authority for formulating accounting policy at Fannie Mae?
A: Jonathan [Boyles] has the authority for recommending a specific accounting policy. Leanne [Spencer] has line responsibility for what policy is actually adopted. And I have general responsibility for ensuring that the process works well and produces a quality result.

OFHEO believes that these weaknesses resulted in an environment that impeded independent thinking and encouraged an inadequate level of policy and procedure development and documentation. A basic component of good corporate risk oversight is a sound internal control environment supported by a prudent system of "checks and balances" between the risk taking and control functions of an organization. Necessary components of this are both an independent risk management and audit function. Also, those responsible for the transacting or risk-taking business should not responsible for the settlements, financial reporting or recording of the transactions into the Enterprise's books and records. [337]

Accounting Policy Development

The financial reporting responsibilities at Fannie Mae reside in the Controller's Department and ultimate responsibility for certification of the financial statements lies with Franklin Raines, Chairman of the Board and Chief Executive Officer (CEO), Tim Howard, Vice Chairman and Chief Financial Officer (CFO) and Leanne Spencer, Senior Vice President and Controller. The Controller's Department, relative to the areas under review, is organized as follows:



Fannie Mae's accounting policy development process begins in the Financial Standards group under the purview of Jonathan Boyles. Financial Standards has the corporate responsibility to recommend accounting policy for Fannie Mae. Jonathan Boyles explained that new accounting policies originate primarily from two sources. First, the Financial Standards group follows new accounting rules as they develop at the FASB, EITF and SEC. If it is determined that the new standards will have an impact on Fannie Mae's business, then Financial Standards will draft accounting policy for recommendation to the Controller. Secondly, the Financial Standards group receives requests from the business units to review new and/or proposed business products developed at Fannie Mae, and Financial Standards will develop accounting policy for

[337] Group of Thirty, Enhancing Public Confidence in Financial Reporting, Washington DC, 2003, p. 14. "Financial control and risk management must be fully independent of the risk taking side."

recommendation to the Controller. The Controller is then responsible for reviewing the proposed policies for compliance with GAAP and ensuring that the financial accounting practices implemented are done so in a safe and sound manner.

During the Special Examination, OFHEO found no evidence of formal written procedures which govern the development of accounting policy at Fannie Mae. In fact, when questioned about documentation of the accounting policy development procedures, Jonathan Boyles indicated that he was not aware if any existed:

> Q: Jonathan, is there a formal procedure for that to take place?
> A: I'm not sure what you mean by a formal procedure.
> Q: A formal procedure for the business unit to contact you.
> A: There's a policy that they're supposed to contact me.
> Q: Is that in writing anywhere?
> A: I don't know that it's in a policy manual out to people. I don't know that it's in writing or not.[338]

OFHEO believes that maintaining formal accounting policy development procedures is necessary to meet management's responsibility for adopting sound accounting policies and devising a system of internal control that will help assure the production of proper financial statements, as outlined in SAS 1. The lack of written policy development procedures results in a disorganized process and the improper development of Enterprise's policy.

In fact, OFHEO noted that the development of the *Purchase Premium and Discount Amortization Policy*, a critical accounting policy for the Enterprise, was directed by Mr. Tim Howard, with significant involvement by Ms. Leanne Spencer and other members of the Controller's Department. However, the policy was developed without input from the Financial Standards group. During testimony, Jonathan Boyles commented on Financial Standards' involvement in the policy as follows:

> Q: Are you familiar with this document [Purchase Premium and Discount Amortization Policy]?
> A: Yes.
> Q: Is this document a policy of the Enterprise for amortizing purchase premium and discount?
> A: I believe this policy, this document is a procedures document for amortization.
> Q: And would you describe this procedures document as being distinct from a policy document?
> A: Yes, I would. I would consider this two different things.
> Q: Now this is maintained outside of your accounting policy manual; correct?
> A: Correct.
> Q: Now did you approve this document?
> A: I don't recall approving this document.
> Q: Do you recall reviewing this document at the time that it was adopted?
> A: I don't recall reviewing this document at the time it was adopted.[339]

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[338] OFHEO Interview, Jonathan Boyles, August 3, 2004, pp. 11-12.
[339] OFHEO Interview, Jonathan Boyles, August 24, 2004, pp. 7-8.

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It should be noted that although during testimony Jonathan Boyles specifies that the document represents procedure rather than the Enterprise's policy, Fannie Mae provided the *Purchase Premium and Discount Amortization Policy* referenced above in response to an OFHEO subpoena requesting the Enterprise's accounting policies related to SFAS 91.

This occurrence highlights the disorganization that results when clearly defined policy development procedures are not in place. Moreover, upon review of the *Purchase Premium and Discount Amortization Policy*, Jonathan Boyles indicated that aspects of that policy do not comport with GAAP:

> Q: I'd like to refer you then to the last page or second page of this document [Purchase Premium and Discount Amortization Policy], FMSE 074524, and I wanted to specifically ask about two policy provisions.
> A: Uh-huh
> Q: And these policy provisions are both indicated in the last paragraph. Do you want to read that last paragraph again?...
> A: Okay.
> Q: The first sentence of this paragraph states: If our catch-up moves beyond one within two percent of combined portfolio net interest in guaranty fee income, we will book monthly "on-top" adjustments that bring us back to within the plus or minus one percent range within our three-year planning period. Is that a provision that you recollect discussing with the outside auditors, KPMG?
> A: I don't recall discussing that provision.
> Q: Is that a provision that you had approved at all?
> A: I don't recall approving it.
> Q: Okay. In your opinion is that provision permitted under Generally Accepted Accounting Principles?
> A: No, I don't believe that would be allowed.
> Q: Then there is, I'd like to direct your attention to the last sentence.
> A: Uh-huh
> Q: States that –I'm sorry—the last two sentences state: Should our catch-up ever exceed two percent of the combined portfolio interest and guaranty fee income, however, we will bring it back to within the one to two percent range within a six month period. After that time, we will continue our monthly "on-tops" to return the catch-up to the plus or minus one-year range within a three-year horizon. Is that policy provision—let me rephrase that. Do you recall having discussed that policy with the outside auditors?
> A: I don't recall discussing this second page with the outside auditors.
> Q: Okay.
> A: As I mentioned earlier, I was surprised when I saw it in April or May.
> Q: Would the policy—I'm sorry—would that provision in that paragraph, in your opinion, be in accordance with Generally Accepted Accounting Principles?
> A: No, I don't believe it would be. I don't believe anything on this—that I'm aware of—on the second page has ever been implemented in practice.[340]

[340] OFHEO Interview, Jonathan Boyles, August 24, 2004, pp. 11-13.

OFHEO contends that the lack of formal policy development procedures within the Controller's Department resulted in the formation of accounting policies that are not consistent with GAAP.

During our examination, OFHEO identified other instances, related to the accounting policies for hedge accounting under SFAS 133, in which aspects of the policy did not comport with a strict compliance with GAAP. During testimony, Jonathan Boyles characterized these instances as "known departures from GAAP," and claimed that they represented a practical application of the accounting standards:

> Q: With respect to the overall approach and the concept of assuming no ineffectiveness, do you believe that there are situations in which Fannie Mae is applying that when it's not consistent with the guidance in FAS 133?
> A: We have several known departures from GAAP in our adoption of FAS 133. We have cleared those with our auditors. We have reported to our auditors on an annual basis the effect of those. And they were comfortable when we adopted them, and they were comfortable over the last several years when we reported the results of that work.
> Q: What were the reasons for you not applying GAAP in its strict conformity?
> A: As is relates to what?
> Q: As it relates to 133. You said there were several departures from GAAP.
> A: The purpose there was really twofold: one, we felt like in the case of the duration shortcut, we felt—if you think about duration, duration is a sensitivity of an instrument's –of the instrument to interest rates. And so, you know, FAS 133 built in the concept of a shortcut so you can match notionals and match maturities and repricing dates and assume no ineffectiveness when really a better economic hedge would be to match duration, not notionals. If somebody on the business side wanted to eliminate interest rate risk, they wouldn't necessarily match up notional or maturity. They would match up durations. Those durations would get you that. When we developed the duration shortcut, we felt like it was in the spirit of 133 while not exactly to the letter, and so we built that into our adoption of 133 because we felt like that was within the tenets of 133 of a match, and then on an annual basis, we would report back to our auditors and the management what the effect of – had we gone long haul on those transactions and not taken the duration shortcut, what that effect would have been on earnings.[...][341]

However, testimony of the CFO indicates that he was not apprised of these "known departures from GAAP" that existed within the Enterprise's accounting policies:

> Q: Do you believe that all elements of the Enterprise's accounting policies are consistent with Generally Accepted Accounting Principles?
> A: Yes, I do.
> Q: And would you have held that belief as well for the last several years?
> A: Yes.[342]
> Q: We understand from Jonathan Boyles' testimony that the company identified certain instances in which the company's accounting practices or policies depart from GAAP. Is that consistent with your understanding?
> A: No, It's not.

[341] OFHEO Interview, Jonathan Boyles, August 3, 2004, pp.64-65.
[342] OFHEO Interview, Timothy Howard, August 5, 2004, p.53.

Q: And he's never informed you of instances where – that he would characterize as known departures from GAAP?
A: I have not heard that term.[343]

In this instance, the lack of formal accounting policy development procedures has led to a breakdown in communication regarding the Enterprise's accounting policies compliance with regulatory standards. OFHEO noted that this instance is particularly egregious given the CFO's responsibility for certifying the financial statements with the SEC. The lack of communication between Financial Standards and the CFO is a result of the internal control weaknesses that result in the absence of written accounting policy development procedures.

Additionally, a review of evidence gathered during the Special Examination highlighted instances in which personnel within Financial Standards characterized aspects of the Enterprise's hedge accounting policies as being aggressive. In an email dated August 10, 2000 with the subject line, *Receiver Swaption + Bullet Swap = Cancelable Swap?*, a former Senior Project Manager within the Financial Standards group writes:

"We could not analogize the combination of the bullet swap and the swaption to be treated like the cancelable swap and qualify for the shortcut method. As it is, using the cancelable swap under the shortcut method is very aggressive."[344]

In a subsequent email dated April 17, 2001 to several members of management, including Tim Howard and Leanne Spencer, with the subject line, *Recent FASB proposal on the time value of option*, Mr. Boyles writes:

"Secondly, the accounting treatment we currently utilize for our received fixed swaptions is aggressive (we have KPMG's approval) and not one we would want to flash in front of the FASB for comment or the treatment could get worse."[345]

During testimony, the CFO expressed a level of awareness and tolerance for the aggressive nature of the Enterprise's accounting policies:

Q: Has any company officer or employee ever informed you that the company's accounting policies or interpretation of accounting policies was aggressive?
A: Certain policies, not in the plural but in the singular, have been described as such at various times. And again, I don't view that as alarming or inappropriate.[346]

However, based on evidence reviewed during the Special Examination, OFHEO believes that the Audit Committee of the Board of Directors was not apprised, at the time they were

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[343] OFHEO Interview, Timothy Howard, August 5, 2004, pp. 59-60.
[344] Email from Kimberly Stone, to Joseph Rosenberg, and cc to Jonathan Boyles, Donald Sinclair, Warren Fitzgibbon and Mary Lewers, dated August 10, 2000, Subject: Receiver Swaption + Bullet Swap = Cancelable Swap ?, FMSE 078731-078732.
[345] Email from Timothy Howard to Jonathan Boyles and cc to Leanne Spencer, Tom Lawler, Peter Niculescu, Linda Knight, Jayne Shontell, Janet Pennewell, Hal Gann, Mary Lewers, Richard Swick, Kimberly Stone, Richard Stawarz, dated April 17, 2001, Subject: Recent FASB proposal on the time value of options, FMSE 096460-096461.
[346] OFHEO Interview, Timothy Howard, August 5, 2004, pp. 49-50.

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implemented into the Enterprise's accounting policies, of these "known departures from GAAP" and instances where the Enterprise adopted aggressive accounting policies. During testimony, when questioned regarding whether the accounting policies characterized as being aggressive were reported to the Audit Committee, Tim Howard responded as follows:

> Q: Has Jonathan Boyles ever informed you that the company's accounting policies or interpretation of accounting policy were aggressive?
> A: I'm almost certain he has, but I can't recall a specific instance.
> Q: Would you ever then inform the Audit Committee of the board of such an opinion held by your Financial Standards head?
> A: No, because again, I don't view the label aggressive accounting as being a bad thing. It is descriptive of relative positioning compared to the GAAP line. That's why I want to find out more about the specific incidents. And if it's uncomfortably close to the line, we will change it. It's not take it to the board. It's don't do it.
> Q: Have you ever informed the board or Audit Committee of the board of such an opinion held by your Financial Standards Department head?
> A: Not to my recollection.[347]

OFHEO believes that the control weaknesses identified in the accounting policy development process at Fannie Mae have allowed the formation of accounting policies that are aggressive in nature and which do not comport with GAAP. Additionally, OFHEO contends that the lack of formal policy development procedures has resulted in a breakdown in communication regarding the Enterprise's policies compliance with regulatory standards and less than full disclosure to the Audit Committee of the Board of Directors.

In addition to the weaknesses that exist within the control environment surrounding the accounting policy development process, evidence suggests that for the period under review, the Enterprise did not maintain a complete and updated database of accounting policies which could be easily accessed by Fannie Mae personnel. During testimony, the Controller asserted that the general structure for maintaining accounting policies at Fannie Mae is in the Financial Accounting Policy Guide, which is periodically updated and posted to the Enterprise's intranet. However, during the examination, OFHEO identified instances in which critical accounting policies were maintained outside of the designated online database for accounting policy and outside of the offline Financial Accounting Policy Guide. In order for the accounting policies to be effective, it is imperative that the business units who rely on the guidance to evaluate proper performance of business operations, have access to a complete accounting guide listing all of the Enterprise's accounting polices and procedures.

Accounting Policy Review

The internal review of proposed accounting policies is performed by the Controller. During testimony, the CFO confirmed that it is ultimately the Controller's responsibility to decide which policies to approve and implement. The CFO further explained that he views the Controller's position as an "internal check" on the Financial Standards group.[348] During our examination,

[347] OFHEO Interview, Timothy Howard, August 5, 2004, pp. 50-51.
[348] OFHEO Interview, Mr. Tim Howard, August 5, 2004, pp. 19-20

OFHEO noted that while the Controller has the responsibility for reviewing proposed accounting policies for compliance with GAAP, she is not a Certified Public Accountant (CPA). The accounting policy development process as currently practiced is circular as the Controller relies on the Financial Standards group to provide guidance on whether or not accounting policies conform to regulatory standards. The effective result of the process as described is that the Financial Standards group develops and also approves accounting policy.

Furthermore, during testimony, the CFO indicated that in situations where the Controller has a difference of opinion from the accounting policy recommendation developed by Financial Standards, the matter is brought to him for a final decision:

> Q: Since Jonathan provides recommendations to Leanne, I assume implicit in her authority is the ability to evaluate those recommendations, but ultimately establish policy she judges to be appropriate, which may in fact deviate from Jonathan's recommendations.
> A: In theory that could happen. What's occurred in practice, for as long as I can remember, is when that is the case, Leanne does not make those decisions without consultation with me, which is—that's something that I have put in to practice as a, I think, good process check. Again, if you have a recommendation for the subject matter expert, that his or her supervisor—there's a difference of a point of view, there's an issue there. And one of the things that I am good at doing in the company is ferreting out the merits and drawbacks of resolving issues in different ways. So I am invariably asked to participate in the process. And then whatever the final judgment is, I will likely be involved in it.
> Q: And I assume that that's actually happened, that it's not just hypothetical?
> A: Yes, it has. Again, if you ask me for specific recollections, I would probably rack my memory to come up with one. But it doesn't just work that way in the controller's area. It works that way in all areas that I oversee. That's the one way I think I add some benefit, by holding the various responsibilities I've got.[349]

It should be noted that the CFO is also not a CPA nor does his technical background include accounting related experience. OFHEO does not believe that the accounting policy development review process is sufficient to function as a "check" on the propriety of accounting policies as it relates conformity with GAAP.

OFHEO questioned the Controller about the process that she undertakes to ensure that the Enterprise's accounting policies are in compliance with GAAP. The Controller responded that

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Q: How would you describe the distinction of responsibilities between Financial Standards headed up by Jonathan [Boyles], and then alternatively, Leanne Spencer and the Controller's Group that she oversees?
A: Well, Jonathan is the subject matter expert on accounting policies, so he is the person that we look to for not only advice but decisions around how to implement the various financial standards requirements. Leanne is supervisor, overseer. She is a internal check on Jonathan, and in my role as sitting on top of the overall department, I look first to Jonathan for his subject matter expertise, do rely on Leanne's thoroughness in engaging on issues and her sense for when an issue needs to come to my attention, and frequently issues are brought up to me, both to inform me, and in some cases to seek my counsel on decisions. So that's how I think about it. Jonathan's the subject matter expert, and Leanne is an engaged participant in the process.

[349] OFHEO Interview, Timothy Howard, August 5, 2004, pp. 24-26.

she relies on the advice of the external auditor in determining whether the accounting policies comply with regulatory standards:

> Q: How do you assure yourself that the company's policies are in accordance with GAAP?
> A: I hire technical experts to staff the Financial Standards Unit, and then I liberally use our external auditors and our external auditors' national office to review policy and to have check-offs on the policy, and we really are in a mode to where we check with them frequently, and we want to make sure we don't have habits where we move forward and then inform them of what we did. Our habits are have them along with us, and be with us along the way as we are looking at items of a policy nature.[350]

As noted above, SAS 1 states that it is the responsibility of management to develop sound accounting policies as the primary responsibility for the financial statements rests with management. Part of that responsibility includes devising a system of internal control that will, among other things, help assure the production of proper financial statements. The standard also describes the scope of an auditor's activity: "As part of their audit, they will assess the accounting principles used. However the auditor's responsibility for the statements he/she has examined is confined to the expression of his/her opinion of them. The financial statements remain the representation of management."[351] It is the responsibility of management to ensure that the Enterprise maintains the internal expertise to properly develop, approve, and implement accounting policy.

The testimony of the CFO, Controller, Vice President of Financial Accounting, Director of Financial Accounting, and the head of the Office of Auditing, all referred to KPMG as the final arbiter of the Enterprise's compliance with GAAP.[352] This provides insight into management's "liberal use"[353] of its external auditors as the first check on the appropriateness of the Enterprise's accounting policies. However, it is ultimately the responsibility of management to determine sound accounting policies for the Enterprise[354] – the burden of management can not be shifted to the external auditor. OFHEO views the Enterprise's reliance on the external auditor to determine the propriety of accounting policy as an indication of a lack of adequate

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[350] OFHEO Interview, Leanne Spencer, August 12, 2004, pp. 24-25.
[351] American Institute of Certified Public Accountants (AICPA) 2002 *Codification of Auditing Standards and Procedures,* Statement of Auditing Standards No. 1, Section 110.02. New York, NY: AICPA.
[352] OFHEO Interview, Mr. Tim Howard, August 5, 2004, pp. 19-20
Q: How would you describe the distinction of responsibilities between Financial Standards headed up by Jonathan [Boyles], and then alternatively, Leanne Spencer and the Controller's Group that she oversees?
A: Well, Jonathan is the subject matter expert on accounting policies, so he is the person that we look to for not only advice but decisions around how to implement the various financial standards requirements. Leanne is supervisor, overseer. She is a internal check on Jonathan, and in my role as sitting on top of the overall department, I look first to Jonathan for his subject matter expertise, do rely on Leanne's thoroughness in engaging on issues and her sense for when an issue needs to come to my attention, and frequently issues are brought up to me, both to inform me, and in some cases to seek my counsel on decisions. So that's how I think about it. Jonathan's the subject matter expert, and Leanne is an engaged participant in the process.
[353] OFHEO Interview, Leanne Spencer, June 22, 2004, p. 24-25.
[354] American Institute of Certified Public Accountants (AICPA) 2002 Codification of Auditing Standards and Procedures, Statement of Auditing Standards No. 1, Section 110.02. New York, NY: AICPA.

technical expertise within the Controller's Department. OFHEO believes that although the Controller has the ultimate responsibility for approving accounting policies at Fannie Mae, the processes as practiced rely heavily on the SVP of Financial Standards and the external auditor to determine compliance with GAAP. OFHEO asserts that the accounting policy review process does not provide a sufficient internal independent verification of recommended policy and does not provide reasonable assurance that the accounting policies adopted by the Enterprise are in compliance with GAAP.

Additionally, OFHEO noted that although internal audit procedures indicated that test work was performed to assess compliance with regulatory standards, the Office of Audit (OA) does not conduct an independent review of accounting policies to determine compliance with GAAP. According to the CFO, Internal Audit has no role in determining whether or not Fannie Mae's accounting policies are consistent with GAAP. The CFO asserts that the role of the OA is to evaluate the internal controls of accounting processes relative to the internal policy:

> Q: What is Internal Audit's responsibility for evaluating the company's accounting policies?
> A: Their primary responsibility is to do audits to ensure that the policies are followed by those they govern in a fashion consistent with our [internal] standards.[355]

As it relates to the review of accounting policies, the CFO does not look to the OA to review the Enterprise's accounting policies for propriety under GAAP; he instead looks to the outside auditor. Sam Rajappa, Senior Vice President of Operations Risk (Director of the Office of Audit) confirmed that his team does not provide any review of the Enterprise's accounting policies relative to GAAP:

> Q: Are audit procedures directed at determining whether or not the company has been in compliance with GAAP?
> A: Audit procedures are directed at auditing to the standards established by Financial Standards and approved by KPMG.[356]

Fannie Mae's organizational structure and accounting policy development review process has created material deficiencies in the Enterprise's ability to effectively review financial accounting policies. OFHEO determined that as a result of the lack of technical skill of the executives who serve as a control check of the policy development process, management over relies on the SVP of Financial Standards and the external auditor to perform this key function. OFHEO believes that the policy development review process, as currently practiced, does not adequately fulfill management's responsibilities, which has resulted in the development of accounting policy that is aggressive in nature and an environment that acquiesces to the development of policies that do not comport with a strict interpretation of GAAP.

Segregation of Duties

OFHEO examined the roles and responsibilities of the executives in the Controller's Department and the related controls that support the integrity of the financial reporting process. During the

[355] OFHEO Interview, Timothy Howard, August 5, 2004, p.36.
[356] OFHEO Interview, Sam Rajappa, June 17, 2004, p.10.

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examination, OFHEO noted several instances in which the executives in the Controller's Department lacked a proper segregation of duties. One example of this is the lack of segregation of duties regarding the amortization of deferred price adjustments. OFHEO believes that these instances represent critical conflicts of interest and are not conducive for developing safe and sound financial reporting practices. Statements on Auditing Standards 55 (SAS 55) issued by the Auditing Standards Board (ASB) "provides guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards," as follows:

> **Control Procedures**
> 11. Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved[...]
>
> - Segregation of duties that reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties – assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets[...][357]

The standard emphasizes the importance of segregating responsibilities of individuals who are in a position to authorize and record transactions in establishing a strong control environment around financial reporting.

Chief Financial Officer (CFO)

OFHEO noted that the CFO has a myriad of responsibilities, which include risk management, the retained portfolio, the accounting function, investor relations, treasury, and financial reporting and he also has responsibility for evaluating and making compensation recommendations for the Head of the Office of Auditing, Mr. Sam Rajappa. When asked to describe his current position at Fannie Mae, the CFO responded as follows:

> Q: I want to start off with just some questions related to your background and experience. Can you describe your current position at Fannie Mae?
>
> A: Boy, how much time do we have? [Laughter.]
>
> A: My title is vice chairman and chief financial officer. As vice chairman I have a fairly wide range of corporate strategy oversight management responsibilities, part of a four-person Office of the Chairman includes Frank Raines, the chairman and the chief operating officer and Tom Donilon, who's executive vice president for law and policy.
>
> Beyond that, I also serve informally as the Enterprise's chief risk officer. Back, I guess, in November of 2000 Frank asked me to take on those responsibilities, and we effectuated that by moving the credit policy function out of the reporting, the chief operating officer reporting to me, and that gave me direct reports of all people who

[357] American Institute of Certified Public Accountants (AICPA) 2002 *Codification of Auditing Standards and Procedures*, Statement of Auditing Standards No. 55. New York, NY: AICPA.

either set risk policy or did risk analytics. So that's a second level of responsibilities I have.

I direct the person who manages our on-balance sheet mortgage portfolio. That's Peter Niculescu. Prior to November of 2002 I had direct oversight responsibility for the three functions that composed that business, the portfolio strategy function, the mortgage acquisition function, and the Treasurer's Office. In November that passed to Peter, but I retain active involvement as a overseer of the business.

As chief financial officer I have the accounting control function, with Leanne Spencer heading that up, reporting to me. In addition to financial reporting, we also do business planning, tax, and accounting policy. Investor Relations reports to me directly.

A small group called Corporate Financial Strategies, headed by Tom Lawler, who I believe you talked to, serves as a standard setter and the group that ensures that we're looking at risk consistently across the company. Tom reports to me.

And finally I have, indirect or dotted line reporting from the auditor. Sam Rajappa reports directly to the chairman of the audit committee, but for the last I think year and a half, maybe two years, he has reported on a dotted line basis to me. Previously he also reported to our chief operating officer.

So that covers the range of responsibilities I currently have. Like in the past I've had others, but not significantly different from what I have now.[358]

The CFO indicated a wide range of functions that fall within his purview of responsibility, several of which potentially impair the CFO's independence. According to the best practices outlined in, *Enhancing Public Confidence in Financial Reporting*, written by the Group of Thirty, "financial control and risk management must be fully independent of the risk taking business."[359] The Group of Thirty is comprised of members from both the public and private sectors and academia. The Group issues guidance on economic, financial, and policy development. In fact, during his testimony, Mr. Howard stated that he is currently serving as a member of The Group of Thirty:

Q: Have you yourself been involved in meetings with standard setters, accounting standard setters such as the SEC or FASB to discuss the company's accounting policies?
A: Both. I've been a number of meetings with FASB board members, including the chairman, and also been to the SEC. And one other thing I'll mention that falls into that category is there is an outfit called the Group of 30, that you may or may not have heard of. It's a group of basically international financial policy makers that are the board of a nonprofit headquartered here in Washington. Last year they decided to do something they've never done before which is attack accounting policy, and they put together a steering committee.

[358] OFHEO Interview, Tim Howard, August 5, 2004, pp. 6-8.
[359] *Enhancing Public Confidence in Financial Reporting*, The Group of Thirty, Washington, D.C., p.14.

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> The chairman of the board of trustees is Paul Volcker, who I've known for some time. Paul asked me to serve on the task force to look at the issue of fair value versus historical cost for international financial institutions. But Bob Herrs [ph] was on that as a observer, Susan Bies from the Fed, Jim Leisenring from the IASB. So that's an accounting policy group. I also head that interaction. We met three times in the course of putting together our report, twice in New York and once in London.[360]

As part of his responsibility for the retained portfolio, the CFO has the authority to approve transactions related to mortgage acquisitions and derivatives. He also has the authority to set risk management strategies which are used to develop the financial forecast. Additionally, he has the authority to determine how the financial transactions are reported in the financial statements. This lack of segregation of duties is inappropriate and contradicts the following public statement made by Franklin Raines, Fannie Mae's CEO:

"Those entering into business transactions and accountable for business results do not determine the accounting of those transactions."[361]
– Franklin D. Raines

OFHEO asserts that commensurate in the CFO's responsibility is the ability to set a financial target through his duties as Vice Chairman and the ability to meet the financial target via his duties as CFO.

Best practices necessitate controls that ensure the independence of management. In addition, while executive compensation for management is ultimately the responsibility of the Compensation Committee of the Board of Directors, the CFO significantly influences the evaluation and makes compensation recommendations for the head of the OA. OFHEO contends that this reporting line is inappropriate.

Senior Vice President – Financial Reporting and Planning

During discussions with Janet Pennewell, Senior Vice President – Financial Reporting and Planning, OFHEO noted a similar conflict of interest corresponding to her roles and responsibilities. When asked to describe her current responsibilities, Janet Pennewell indicated that she is responsible for forecasting the financial statements as well as financial reporting:

> Q: So in 1999 you took on the responsibilities in Financial Reporting that you—describe what happened in 1999 again, if you would.
> A: Sure. In 1999 I was promoted to Vice President, and before my promotion I was in charge of the business planning function, which resides within the Controller's Department, and when I was promoted to Vice President in 1999, also took on responsibility for financial reporting and for financial accounting.
> Q: In 1998 were your responsibilities in the business planning function quite a bit different from what you started doing in 1999?

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360 OFHEO Interview, Tim Howard, August 5, 2004, pp. 39-40.
361 See, Answers from the CEO: Why do you have confidence that you have done your derivative accounting properly?," http://fanniemae.com/ceoanswers/derivativesaccounting.jhtml.

> A: I retained the responsibility for the business planning function, but then took on additional, significant additional responsibility.
> Q: Right. So in 1998 would you have had any responsibility for forecasting income?
> A: Yes. That's what—that's what the Business Planning Group does. It forecasted essentially profit and loss statement, balance sheets for the company as a whole, out of our three or four-year planning horizon, and also for our business areas.[362]

OFHEO asserts that this dual role presents a significant conflict of interest. Janet Pennewell, in her role as SVP of Financial Reporting and Planning, has the ability to affect the amounts of reported net income in order to achieve planned results.

During testimony, Janet Pennewell further described that her responsibilities included modeling the purchase premium and discount amortization as well as recording the amortization to the financial statements:

> Q: So some of the—in forecasting income back in 1998 you also—would you have also had some oversight over the tracking of premium and discount amortization?
> A: In—not officially. We began, my team and myself, began to get involved peripherally in the tracking of premium—the modeling of premium and discount amortization in maybe mid 1998, and then the responsibility for the modeling necessary to come up with the level yield factors was transferred to my area officially in 1999.[363]

Having the dual responsibility of modeling the amortization and reporting amortization results to the financial statements under the authority of a single individual is a major control weakness that undermines the integrity of the financial reporting process.

Director of Financial Reporting

In addition, OFHEO noted that a single individual is responsible for the modeling, reporting and accounting for SFAS 91. During his testimony, Jeffrey Juliane, Director of Financial Reporting, explained his responsibilities related to the purchase premium and discount amortization process as follows:

> Q: Can you walk us through your employment at Fannie Mae?
> A: I came on at Fannie Mae. I was working in the corporate planning area in charge of the mortgage portfolio forecast, worked extensively with the mortgage portfolio area in terms of generating their quarterly forecast numbers and stayed. That was my primary focus for the first year of employment there.
>
> At that point in time, we had Jonathan Boyles' area was responsible for doing FAS 91 calculations. We identified a need to increase the expertise in that area. Then it came underneath me in Q1 of 1999, so at that point in time I had a combined role of doing a corporate plan from the portfolio perspective as well as doing FAS 91 forecasting or FAS 91 accounting.

[362] OFHEO Interview, Janet Pennewell, June 15, 2004, pp. 8-9.
[363] OFHEO Interview, Janet Pennewell, June 15, 2004, p. 9.

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That stayed that way until mid-2000 and then I moved over to be a part of the financial reporting team where I was in charge of new product development from the accounting perspective as well as FAS 91. That stayed that way until toward the end of 2001 when I got asked to help do accrual accounting implementation on a STATs system as well as doing FAS 91....

Q: And who do you report to?
A: I formally report to Mary Lewers.
Q: And you say formally?
A: (Witness nods)
Q: Can you explain that?
A: For—I've always had a dotted-line relationship with Janet, especially when it comes to FAS 91 related activities.
Q: That would be Janet Pennewell?
A: Yes.[364]

Jeffrey Juliane is currently responsible for both modeling the purchase premium and discount amortization amount as well as recording that amortization amount to the financial statements. This is a control weakness that subverts the soundness of the financial reporting process as there is no independent check on the amortization modeling, forecasting and reporting processes. Again, OFHEO asserts that Jeffrey Juliane's dual responsibility of calculating the modeled amortization results and recording amortization for purposes of financial reporting represents a conflict of interest and undermines the integrity of the modeling process.

SVP of Operations Risk (Head of Internal Audit)

During testimony, OFHEO noted that Sam Rajappa, Senior Vice President – Operations Risk, serves as the head of the Office of Audit (OA) and reports to the CFO. OFHEO concludes that the OA should independently report to the Audit Committee of the Board of Directors and not to management such as the CFO. Based on evidence gathered during the Special Examination, OFHEO believes that Sam Rajappa does not have independence from the CFO. During testimony, the CFO indicated that he has "indirect or dotted line reporting from the auditor." Tim Howard qualified the statement by noting that, "Sam Rajappa reports directly to the chairman of the Audit Committee, but for the last I think year and a half, maybe two years, he has reported on a dotted line basis to me. Previously he also reported to our chief operating officer."[365] Although the CFO characterized his reporting responsibility as that of a "dotted line," OFHEO noted that the CFO participates in the annual performance evaluation and makes compensation recommendations for Sam Rajappa:

Q: Who does Mr. Rajappa's performance review?
A: I write it, but I do it with very significant input from Tom Gerrity, the chairman of the Audit Committee.
Q: Similarly, for your direct reports, do you also perform their evaluation?
A: Yes, I do.

[364] OFHEO Interview, Jeffrey Juliane, June 8, 2004, pp. 8-10.
[365] OFHEO Interview, Tim Howard, August 5, 2004, p. 8.

Q: Are you also involved in making compensation recommendations for these individuals?
A: Yes. Although for people at the senior vice president level and above, we do it collaboratively. We have a group of executives we call our senior leadership team, which is the Office of the Chairman and six other executive vice presidents, who meet as a group, and talk about the performance of all of our senior officers, and we make the compensation decisions collectively. I will make a recommendation to the group about the compensation of each of my officers, but the compensation is ultimately determined by the results of the discussions that take place at the senior leadership team meeting.
Q: Would you also make the compensation recommendation for Sam Rajappa as well?
A: I do, but that is also determined by the group as a whole.[366]

OFHEO believes that Sam Rajappa should report directly to the Audit Committee of the Board of Directors. The position should be independent from the CFO. The current organizational structure which gives the CFO the authority to evaluate and affect compensation decisions for the head of the OA critically impairs the independence of the OA.

OFHEO also believes that the current roles and responsibilities of the executives within the Controller's Department do not meet management's responsibility to "sufficiently segregate duties in order reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties,"[367] as outlined in SAS 55. As a result, the current control environment is not structured to promote safe and sound financial reporting practices. It should be noted that this conflict of interest and underdeveloped segregation of duties was formally noted on several occasions by the Office of Audit, including in their July 9, 2003 Amortization Audit Report.[368]

Moreover, OFHEO contends that OA failed to follow standards established by the Institute of Internal Auditors (IIA) for evaluating risk exposures relating to impairments of auditor independence and objectivity. IIA standards on individual objectivity provide the following guidance regarding impairments to internal auditor independence:

> Internal Auditors should refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.[369]

During testimony, Sam Rajappa indicated that prior to serving in his current role as the head of Internal Audit, he held the position of Controller for the Enterprise:

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[366] OFHEO Interview, Tim Howard, August 5, 2004, p. 13.
[367] American Institute of Certified Public Accountants (AICPA) 2002 *Codification of Auditing Standards and Procedures*, Statement of Auditing Standards No. 55. New York, NY: AICPA.
[368] The Fannie Mae Audit Report issued by the Office of Auditing on the Amortization Audit dated July 9, 2003 states the following: "We noted key-person dependencies in both the data and modeling processes. A limited number of individuals have a strong understanding of the amortization processes. Improved policies over these areas would provide better support for procedures performed and would reduce key person dependencies." FMSE 023745-023752.
[369] The Institute of the Internal Auditors' Standards for the Professional Practice of Internal Auditing, Attribute Standards – 1130.A1

Q: Mr. Rajappa, could you describe your current responsibilities at Fannie Mae?
A: Yes, I am Senior Vice President for Operations Risk now, and I head up the internal audit function, and I have a staff of 57 auditors, including me.
Q: And how long have you had those responsibilities?
A: I've been in this job since January of 1999.
Q: And what is your prior employment history and responsibilities with Fannie Mae?
A: I was the Controller from 1994 through end of 1998.
Q: And how long have you had those responsibilities?
A: I've been in this job since January of 1999.[370]

Based on Sam Rajappa's testimony, it appears that for the fiscal year 1999, the OA function did not meet IIA standards relative to auditor independence. As Sam Rajappa served as the Controller for the period of 1994 thru 1998 and subsequently acted as the head of the Internal Audit function, he was given the authority to audit his own work, which represents a major conflict of interest.

Key Person Dependency

Information obtained during the examination demonstrates that critical shortages of qualified accounting specialists existed within the Controller's Department during the period under review. The shortage of staff and technical accounting expertise created key person dependencies for crucial accounting policy development areas. The problem was exacerbated as Fannie Mae was challenged with fulfilling the necessary requirements to complete registration with the Securities and Exchange Commission (SEC), while also complying with an increasing number of accounting standards that impacted their business.

The Financial Standards Group

The Financial Standards group, which is headed by Jonathan Boyles, is presently staffed with 8 employees. During testimony, Jonathan Boyles indicated that his Financial Standards staff doubled to reach its current number during the past 18 months.[371] Jonathan Boyles explained that he started as a manager in 1994, at which point in time the Financial Standards group consisted of himself and one direct report:

Q: Could you describe what the progression of your positions and job responsibilities have been during that time?

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[370] OFHEO Interview, Sam Rajappa, June 17, 2004, p. 7.
[371] OFHEO Interview, Mr. Jonathan Boyles, August 3, 2004, pp. 9-10
Q: So what was the size of the group when you started?
A: When I started there were two managers and a director. When my boss moved on there were – I was acting head of the department as a manger, and I had one person reporting to me. After I got promoted I replaced my head count essentially, and for a while there were two people reporting. I don't remember the years, but, you know, got approval for a third. And then gradually got a fourth. And then this past year we hired Greg Ramsey as the lead Vice President.
Q: When Greg Ramsey came in, did the size of the group grow in terms of the people reporting to him, or when did you get from the four to the eight? I am just trying to get a sense of timing.
A: Going from the four to the eight has been within the last 18 months.

A: Sure. I started in 1994 as a manager in the Financial Standards Department. I was promoted to Director of the Financial Standards Department around 1997. I was promoted to Vice President, Financial Standards Department 2001, I believe. And I was promoted to Senior Vice President of Financial Accounting Standards and Corporate Tax in 2004....[372]

Q: So what was the size of the group when you started?
A: When I started there were two managers and a director. When my boss moved on there were--I was acting head of the department as a manager, and I had one person reporting to me. After I got promoted I replaced my head count essentially, and for a while there were two people reporting. I don't remember the years, but, you know, got approval for a third. And then gradually got a fourth. And then this past year we hired Greg Ramsey as the lead Vice President.[373]

It should be noted that SFAS 133 became effective for fiscal years beginning after June 15, 1999; Fannie Mae voluntarily registered its common stock with the SEC effective March 31, 2003, filing reports for the FY2002 financial statements; and SFAS 149 became effective for contracts entered into or modified after June 30, 2003.

In addition to developing accounting policy for the Enterprise, the SVP of Financial Standards and Tax also devotes some of his energies to corporate tax issues. Jonathan Boyles is also called upon to prepare analyses such as due diligence support for counterparties and reviews of investee companies. Financial Standards is also responsible for drafting the language that appears in the publicly filed 10K and 10Q statements and the Administrative Finance Report. Additionally, the group is often required to do special projects such as reviewing accounting issues related to Freddie Mac. Financial Standards regularly provides management with analyses comparing Freddie Mac's financial disclosures to their own in order to highlight issues of concern or explain differing financial statement presentations.[374]

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[372] OFHEO Interview, Jonathan Boyles, August 3, 2004, p. 7.
[373] OFHEO Interview, Jonathan Boyles, August 3, 2004, pp.9-10.
[374] OFHEO Interview, Mr. Jonathan Boyles, August 3, 2004, pp. 12-14
Q: So, in addition to being involved in providing accounting guidance, and you know, could you describe what the full extent of your responsibilities are?
A: The full extent of my responsibilities, as it relates just to accounting policy?
Q: You can start with that, and then – it sounds like you have other responsibilities too. I'd like to hear that too.
A: Right. As it relates to accounting policy, my responsibilities are to provide the accounting policy to the departments within the company and to the Financial Reporting Department. We also provide training to the company if there's a need for accounting training, whether it's on old existing rules or on something new. That will go not just for what affects Fannie Mae, but oftentimes we'll do training on what affects our customers but may not have a direct impact on the company. My role is to provide that guidance to those who are responsible for implementing the guidance, and I act as a consultant and get brought in where necessary. I mean, "I" in that regard, I mean me and my team.
Q: And other responsibilities besides accounting –
A: Other responsibilities that we do, I often get asked to do special projects within the company. We have occasionally bought into, during the dot.com craze, several investments in companies that were in the mortgage market, and that we had an interest in the technology. Me or my team would do due diligence, financial due diligence on those companies as part of the decision-making process, would report up through those who would make that decision. We do due diligence on counter-party risk. We'll go out to

Given the technical accounting support necessary for Fannie Mae to comply with regulatory requirements for implementing the new standards from the FASB and registering its common stock with the SEC along with its regular operational activities, OFHEO believes that Fannie Mae management failed to adequately staff the Financial Standards function to sufficiently meet these requirements. In fact, the Controller commented on the need to increase staffing for the Financial Standards group as part of Jonathan Boyles' 2002 Performance Review:

> I believe FAS 149 knocked us off our horse which had begun to canter. We are only slowly building momentum. In hindsight, and I know you agree, Paul [Salfi] was not nearly strong enough to lead this huge effort. We recognized this and we are taking action to staff your organization appropriately and to add a strong head of accounting policy.[375]

OFHEO believes that management across business operations was aware of the lack of accounting expertise within the Controller's Department.[376] However, management appears to have been slow taking action to remedy the situation.

In addition, based on evidence reviewed during our examination, OFHEO determined that there is limited technical accounting expertise at Fannie Mae, as the SVP of Financial Standards is heavily relied upon for all matters accounting related at the Enterprise. OFHEO noted that executives within the Controller's Department exhibit only a "high level" understanding of the relevant GAAP standards that support the Enterprise's accounting policies.

Controller

When questioned regarding the Enterprise's accounting treatment of interest only (IO) and principal only (PO) securities, Leanne Spencer deferred her comments to Jonathan Boyles citing

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my companies as part of a broader team. We'll do the financial due diligence where others will look at other risks of our counter-parties, and we do other special projects like that, most things as it relates to Freddie Mac and Freddie Mac's accounting gets done out of my department. My department's also responsible for drafting the 10K, the 10Q, and it's responsible for drafting the administrative finance report, both of those.

[375] Performance Review, Jonathan Boyles, by Leanne Spencer, 2002 (FMSE 220363).

[376] The 2003 Performance Evaluation from Tim Howard to Leanne Spencer, dated December 30, 2003, states the following: "The one consistent development theme in the survey was the resource issue. It was mentioned somewhere in the survey by each of the four peers who reviewed you: "she needs to fill out her team and invest more in her functions." "I think the area for development is in realizing how much the world has changed and needing to get ahead of those changes in terms of her organization, resource levels and other investments needed for today's controllership function." "She needs more depth in certain functions." "The fact that her staff is overworked and under such extreme resource pressure is apparent." And one of your direct reports said: "I believe she has a pride issue that prevents her from asking for more help and as a result, she doesn't have more time to actually perform her management duties. Because she runs such a lean shop her employees also don't have much time to develop her skills or attend training." I know you're on top of his now, but as the survey indicates, both you and I let this get a little further along than we should have without raising it up on our priority lists – which our peers clearly noted." FMSE 220315-220318

that she did not have an understanding of the GAAP standards which validate the Enterprise's accounting treatment:

> Q: We're going to talk a little bit about Fannie Mae's accounting for IO and PO securities. Now we understand from some of the previous discussions we've had that the company's policy is to account for IO and PO securities on a combined basis; is that correct?
> A: I have a limited recollection of this area, so I would not represent myself as having expertise in this matter. But I am aware of IO/POs combined. I believe we have talked to you about this before.
> Q: Do you – are you familiar with the criteria that the company uses for making that decision in terms of combining IOs/POs from an accounting standpoint?
> A: I have a high level understanding, but I wouldn't have a detailed – I wouldn't have a detailed understanding.
> Q: Who would have a detailed understanding?
> A: The SVP of Financial Standards, and traders in the portfolio business who he would be interacting with.
> Q: So would you have an understanding of what basis in GAAP was used to get to that conclusion?
> A: I would not.[377]

As the corporate Controller is considered a critical member of the management team at Fannie Mae, OFHEO finds her inability to comment on the regulatory accounting standards which govern the Enterprise's accounting policy unacceptable. Particularly in light of the CFO testimony that he viewed it as ultimately the Controller's responsibility to decide which accounting policies to approve and implement.

Evidence reviewed as part of the Special Examination indicated that the Controller's function was also overworked and had persistent resource issues during the period under review. In the Controller's 2001 performance review, the CFO made the following comment regarding workload management and staff development within the Controller's Department.

> Once we get overloaded, things slip. They don't get done as thoroughly, with the degree of coordination, or in the right priority as would be the case otherwise.[378]

The Controller's 2002 performance report echoed the 2001 report. The CFO urged the Controller to focus on staff development and coaching.[379] Also, the CFO noted the following feedback from fellow officers regarding the lack of resources in the Controller's function. A survey revealed that the lack of resources in the Controller's Department

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[377] OFHEO Interview, Ms. Leanne Spencer, August 12, 2004, pp. 68-70.
[378] 2001 Performance Review: Leanne Spencer, by Timothy Howard (FMSE 220309).
[379] The 2002 Performance Evaluation from Tim Howard to Leanne Spencer, dated December 30, 2002, states the following: "Truth to be told, Leanne, it was your subordinates' comments about your attention to their development needs that caused me to hesitate to recommend you for "SE" consideration this year, notwithstanding the phenomenal year you had on the results side. If you get your people development skills up, you should be able to waltz across the SE goal line." FMSE 220311-220314.

was identified across business functions and these comments were noted in Leanne Spencer's 2003 annual performance review:

> "She needs to fill out her team and invest more in her functions."
>
> "I think the area for development is in realizing how much the world has changed and needing to get ahead of those changes in terms of her organization, resource levels and other investments in today's controllership function."
>
> "She needs more depth in certain functions."
>
> "The fact that her staff is overworked and under such extreme resource pressure is apparent."
>
> "Because she runs such a lean shop her employees also don't have much time to develop their skills or attend training."[380]

Interviews with other executives within the Controller's Department revealed a similar limited knowledge of accounting standards and indicated a significant reliance on Financial Standards regarding technical accounting matters.

Vice President for Financial Accounting

During testimony, Mary Lewers, Vice President of Financial Accounting, indicated that she has been employed at Fannie Mae for 21 years working in various financial accounting positions. Mary Lewers noted that the responsibility to produce accurate financial statements rests with others. She insisted that her responsibility is limited to accounting operations and ensuring that "...the transactions are processed and that the accounting is appropriate as per the guidance that would have been provided to my team."[381]

> Q: So, with respect to these various areas then, is it your group's responsibility to ensure that the transactions are accounted for properly in accordance with generally accepted accounting principles?
> A: The responsibility of my group would be to work alongside the Financial Standards group. The Financial Standards group would establish the Fannie Mae's policy for Accounting. And so then the individuals on my team would be; their responsibility is to manage the processes and to ensure that our accounting is in compliance with that policy.[382]

OFHEO noted that she characterized her current level of knowledge as limited regarding amortization of purchase premium, insisting that she is still working on developing an

[380] 2003 Performance Review: Leanne Spencer, by Timothy Howard (FMSE 220317).
[381] OFHEO Interview, Mary Lewers, July 13, 2003, pp. 15-16.
[382] OFHEO Interview, Mary Lewers, July 13, 2003, p.20.

understanding of the broader concepts behind FAS 91.[383] Mary Lewers testified that she is becoming familiar with this area for which she currently has the responsibility to manage. She was assigned these duties in 2003.

When questioned regarding aspects of the Enterprise's hedge accounting policies and its compliance with GAAP, Mary Lewers asserted that she relies on Financial Standards to determine compliance with regulatory standards:

> Q: Do you believe it is in compliance with FAS 133, the specific discussion that we've just had in terms of having just a second swap at the inception of the second hedge relationship be equal to zero?
> A: I have been--I'll go back to kind of what I said earlier. FAS 133 is a very technical area of accounting, and it's one that I rely upon the expert advice of the Financial Standards Group to establish our policy, and that my understanding of our policy is that we assess the fair market value of zero at the beginning of each of these hedge instruments that we enter into and that that's the point where we apply that test.
> Q: So does that mean--is your answer implying that you think it's consistent with FAS 133? ...
> A: And I'll go back to that I have found that FAS 133 is a very complicated area of accounting, and it's one that I look to get expert advice on how to interpret--the interpretation into our policy, and so I rely upon the information supplied to me by Accounting Standards, and that that appears to be appropriate accounting to me based on that advice.
> Q: You're a CPA yourself, right?
> A: Yes, I am.
> Q: Have you given these issues a great deal of thought yourself?

[383] OFHEO Interview, Ms. Mary Lewers, July 13, 2004, pp. 241-243
Q: Ms. Lewers, I think we spoke to you earlier about your involvement in the amortization process on another date. I just wanted to clarify some of that quickly today. Could you tell us what your involvement and responsibility is with respect to the process of calculating amortization?
A: Are you referring to FAS 91?
Q: Yes.
A: Historically, my involvement with FAS 91 has been a very limited component of this accounting. In that accounting I had responsibility for what used to be PDS, became PDI, and the iPDI, which was a system that tracked balances and that received factors from another system, and then the PDS/PDI/iPDI, that system would take balances, apply factors, and then generate an amortization amount that would then be booked to the general ledger. And so that piece of the FAS 91 process was my area of responsibility.
Q: And has that changed at all over time?
A: In the past, I think about last summer maybe, the organization – we did some reorganization of individuals, and so the individuals who have responsibility for this area now reports in to me. And so I'm in what I would call a transition phase in that I have been learning and working developing an understanding of the broader concepts behind FAS 91. But that effectively Janet Pennewell has really been more the supervisor in charge of this area.
Q: I guess in the past year you've been becoming more involved in the process. Is that a fair statement?
A: Well, I haven't really devoted much time to it until the last few months, and my – so I'm not – I have not mastered this subject area.
Q: As of today, if there was an important management decision to be made regarding the process of amortization, would you be involved in that decision?
A: I would probably be involved in hearing the discussion that went on, but I would not be the one making the decision.

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> A: I spend a fair amount of time on this, but I have to also remind everyone that this is not my only area of responsibility, and that my responsibility covers a broad range of accounting topics. This is an area that--so it's one of several areas that I work with, and it's one that has--it's a very technical area and it's one that--there are people in the company, in Fannie Mae, who work on this on a more day-to-day basis than myself.
> Q: FAS 133 is one of the company's critical accounting policies, is that correct?
> A: Yes, it is[384]

OFHEO believes that the Vice President for Financial Accounting does not have sufficient knowledge of the technical accounting requirements related to SFAS 91 and SFAS 133 to adequately perform her duties. Based on Mary Lewers' testimony, it appears that she takes no responsibility for ensuring that the accounting policies that are being implemented are in compliance with GAAP and over relies on the Financial Standards group for interpretation of the accounting standards.

OFHEO noted that staffing shortages also exist in the Controller's department related to FAS 133 accounting. In a memorandum dated February 2, 2004, from Cheryl DeFlorimonte, Director, Accounting and Audit, the situation was described as a crisis:

> This memo serves to bring to your attention, my concern about the limited resources that are currently in place to meet ongoing FAS 133 production challenges, as well as to spearhead the re-engineering initiative.
>
> With one and a half business analysts currently assigned to FAS 133, monthly production operations is in crisis. This situation has been exasperated by the recent DNQ policy change. As a result of this change, there are additional data requirements for monthly processing, new reconciliations and validations, manual overrides and additional manual journal entries. Further, we continue to flush out additional issues associated with this recent policy change.
>
> Coupled with these production challenges, is the increasing demand on our limited resources to spearhead the FAS 133 re-engineering project. Currently, with total resources of one and a half business analysts and a part time contractor to undertake both production and the re-engineering project, we are at high risk for slippage on both fronts. In fact, both activities cannot be successfully performed with the present resources....[385]

Conclusion

OFHEO believes that Fannie Mae failed to adequately exercise their duty to develop sound accounting policies at Fannie Mae. The Enterprise failed to develop an internal control system to ensure that accounting policy was sufficiently developed and reviewed. A combination of heavy workload, weak technical skills and a weak review environment contributed to the development of key person dependencies. Fannie Mae relies on just a few individuals to make key decisions, particularly those related to accounting policy development. A cornerstone of

[384] OFHEO Interview, Mary Lewers, July 13, 2003, pp.152-153.

[385] Memorandum attached to email from Cheryl DeFlorimonte to Leanne Spencer, Subject: FAS 133 Resources, dated February 2, 2004, DeFlorimonte 08112203

sound corporate oversight is the control structure itself. The board of directors and management are responsible for promoting high ethical and integrity standards, and for establishing a culture within the organization that emphasizes and demonstrates to all level of personnel the importance of internal controls.

It is management's responsibility to ensure that Fannie Mae operates in a safe and sound manner and has proper segregation of duties, an adequate level of controls to support its key business processes, and clear and appropriate accounting policies. In addition, it is management's responsibility to ensure that key control function personnel are competent and qualified to execute their daily responsibilities.[386] OFHEO contends that the CFO, as the primary manager for key financial reporting and accounting areas, failed in providing adequate oversight to key control and reporting functions within the Enterprise. In addition, he developed and rewarded[387] a staff that collectively does not possess the skills necessary to ensure that Fannie Mae has proper accounting policies, adequate resources to support proper implementation of such policies, and an effective system of internal controls.

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[386] Both the Group of Thirty and the Basel Committee on Banking Supervision both emphasize it is management's responsibility to ensure that key control function personnel are competent and qualified to execute their daily responsibilities.
Group of Thirty Report, *Enhancing Public Confidence in Financial Reporting*, Washington DC 2003, p. 14.
Bank for International Settlements, Basel Committee on Banking Supervision, *Framework for the Evaluation of Internal Control Systems*, January 1998, p. 11.
[387] *Id.*, p. 12. The Committee on Banking Supervision also states that, "In reinforcing ethical values, banking organizations should avoid policies and practices that may inadvertently provide incentives or temptations for inappropriate activities. Examples of such policies and practices include undue emphasis on performance targets or other operational results, particularly short term ones; high performance-dependent compensation rewards; ineffective segregation of duties or other controls may offer temptations to misuse or conceal poor performance; and insignificant or overly onerous penalties for improper behaviors.

APPENDIX I

Estimation Methods Used for Modeling the Catch-Up

A. Background

In assessing the methods and discipline applied by Fannie Mae for determining prepayments used to calculate the catch-up, **OFHEO has concluded that Fannie Mae 1) designed and applied estimation methods, and 2) selected assumptions used in the calculation of the catch-up, for the improper purpose of managing its current and prospective financial results. In addition, OFHEO has determined that Fannie Mae applied methodologies for determining prepayment assumptions that were alternatively different for the retrospective adjustment and prospective amortization required under SFAS 91.**

In order to calculate the quarterly adjustment necessary to recognize a constant effective yield required by SFAS 91, the Enterprise needed to calculate the estimated life of the mortgage loans and securities associated with the deferred price adjustments to be amortized. The estimated life of such mortgage assets is a function of expectations regarding the likelihood of consumers to prepay their mortgages, which itself is a function of future interest rates. If future interest rates decline, then consumers would likely be disposed to refinance mortgages they have previously financed at higher rates. Alternatively, if future rates increase, there would be a reduced incentive to refinance since doing so would only result in the consumer obtaining a higher rate mortgage.

The propensity of consumers to refinance is intuitively understood by many. However, the methods for forecasting future interest rates, and determining the impact of these forecasts on the rate at which consumers will prepay their mortgages, is better understood by finance professionals or economists with experience in such modeling. While these professionals themselves may disagree on the specific assumptions and models that may be used to forecast prepayments, there are nevertheless methods, and an accepted discipline in applying those methods, that most such professionals would agree on. **The methods used by Fannie Mae were less sophisticated than the Enterprise had the capability to support, and furthermore produced flawed results.**

The December 2000 policy codified the methodology by which each quarter's catch-up amount would be estimated;

> The catch-up position is calculated using the average of five interest rate scenarios – the base rate together with the four sensitivity runs that encompass a 95% confidence interval around that base rate (currently +/- 60 and 120 basis points[388]).[389] The base rate will normally be consistent with the rate that is used

[388] Basis point (bps) is defined as one hundredth of a percentage point (0.01%).

[389] While the policy to this day specifies that the scenarios around the base rate will be +/- 60 and +/- 120, the interest rate scenarios applied around the base were changed to +/- 50 and +/- 100 immediately after the policy was adopted for the calculation of the Q1 2001 amortization estimate. This range of scenarios was consistently applied for the period 2001 through to the current period in 2004.

> in our most current business plan. However, if circumstances exist that cause us to use a different a different rate path we will document the rationale for the rate path used. At all times the base rate and the standard sensitivities will encompass a 95% confidence interval around the rate that was used.

In providing commentary regarding the functionality of amortization modeling software the Enterprise was using, Ms Janet Pennewell also commented on management's views concerning the use of the multiple interest rate scenarios[390] (also referred to as "rate paths") described in the amortization policy:

> Q: [...] Ms. Pennewell, do you recall any discussion around the ability of BancWare to manipulate factors to produce an array of recognition streams?
> A: Yes.
> Q: And can you elaborate on that?
> A: Sure. At this point your previous question, we talked about a group of us working on how to enhance our models and begin thinking about formalizing a policy for our premium and discount. And again, our thinking really was that you have a current interest rate pattern today, and our recognition was that FAS 91 requires you to try to project what you think the average life of your mortgages is going to be. Obviously, that first requires that you can project what interest rates are going to be, and then within that interest rate path know what prepayments are going to be so that you can get a correct effective life to calculate your constant effective yield.
> And we recognized that we weren't very good at projecting where interest rates were going to be, and even if we could accurately project where interest rates were going to be, that we--that there was then a range of very reasonable prepayment assumptions that would fit with that interest rate projection.
> And so we were in the process of saying, well, we don't want to run one scenario with one interest rate assumption and fool ourselves into thinking that that with precision is, is exactly what our catch-up position is. And so we were beginning the process of figuring out how to put together a policy that would address a couple very key pieces of assumption risk, namely, our ability to forecast interest rates, and our ability to, within an interest rate path, to, with precision to project what prepayments were going to be, and to want to have a modeling tool that gave us the flexibility to potentially, say, use BancWare run 5, 10 different scenarios, maybe in different interest rate paths that might capture the kind of variation that you really would expect to happen in interest rates, and then average them together.
> So BancWare, initially, is my recollection, was set up to say you kind of put in one path of interest rates, and then whatever catch-up number that produces, that you would—the assumption in BancWare was that you would record that to income. Instead we thought what we needed was not just one path of interest rates, but again a range of paths of interest rates where we may want to average them together, recognizing the lack of precision that's inherent in projecting interest rates and prepayments.
> And so then we needed a model that would then give us the flexibility to not just book our entries or produce our factors--because the BancWare and then later AIMS is a system that we used to calculate what--calculate factors that allow us to record the

[390] OFHEO Interview, Ms Janet Pennewell, June 15, 2004, pp. 21-24

> constant effective yield. Those factors the actually get fed into another system which actually calculates the amount that would get booked through the general ledger.
>
> Anyway, so, in order to produce a good set of factors we needed a model that didn't just, say, give me one interest rate path and produce one set of factors. We needed the ability to, as I said, capture a range of assumptions and adjust the factors to reflect that range of assumptions.

B. Development of Amortization Estimation Methods

The first written recommendation by the amortization policy analysis group concerning the modeling of interest rates and prepayments was contained within the September 23, 1999 memorandum[391] to Tim Howard from Janet Pennewell. This memorandum noted that while amortization was estimated and recorded using a single flat rate path, the Enterprise used multiple rate paths (up 75 bps, up 150 bps, down 50 bps and down 100 bps) for the purposes of forecasting earnings. The memorandum went on to state the recommendation that the multiple rate paths used for forecasting, also be used for the purposes of estimating and recording deferred price adjustment amortization.[392] This memorandum further recommended that the forecast be determined using "a probability weighted average of the base plus four standard scenarios."[393]

Another memorandum[394] to Tim Howard, dated December 16, 1999, recommended that the up and down scenarios be established by determining the respective +/- one standard deviation[395] (1 std.) and +/- two standard deviation (2 std.) rate paths. The memorandum further recommended the specific statistical weighting to be assigned to each of the rate paths; weighting values of 30% for the base rate path, 20% for both the up and down 1 std. rate paths, and 15% for the up and down 2 std. rate paths. Other analysis[396] also included within the memorandum suggested that the ranges used for the up and down 1 and 2 standard deviation rate paths be the up 75bp, down 50bp and up 150bp, down 100bp rate paths referenced in the September 23rd memorandum.

While finance professionals and economists may disagree on the specific probabilities associated with upward or downward movements in interest rates, they would most certainly agree that significant (2 standard deviation) upward or downward movements in interest rates are less likely to occur than more modest (1 standard deviation) upward or downward movements. In addition, many finance professionals would also agree that a 1 or 2 standard deviation *upward* movement would be inherently larger than a 1 or 2 standard deviation

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[391] Memorandum from Ms. Janet Pennewell to Mr. Tim Howard, dated September 23, 1999, Subject: Policy on Purchase Premium/Discount Management. FMSE-SP 000106-000109

[392] As far as OFHEO can determine, the Enterprise did not use multiple rate paths to determine the estimate of deferred price adjustments amortization – or catch-up – until after it formally adopted its accounting policy for 'purchase premium and discount amortization' in December 2000

[393] Memorandum from Ms. Janet Pennewell to Mr. Tim Howard, dated September 23, 1999, Subject: Policy on Purchase Premium/Discount Management, FMSE-SP 000106-000109.

[394] Memorandum from Ms. Janet Pennewell and Mr. Jeff Juliane to Mr. Tim Howard dated December 16, 1999, Subject: Catch-up Policy. FMSE 217559-217569.

[395] Standard deviation is a statistical measure of the historical volatility and generally a measure of the extent to which numbers are spread around their average.

[231] Memorandum from Ms. Janet Pennewell and Mr. Jeff Juliane to Mr. Tim Howard dated December 16, 1999, Subject: Catch-up Policy. FMSE 217567.

downward movement. While this last point is debatable, it is clear that thus far in their thinking, Fannie Mae also agreed with this conclusion.

A memorandum[397] dated April 5, 2000 from Mr. Jeff Juliane to Ms. Leanne Spencer provided a first quarter updated 2000-plan analysis of the catch-up. This analysis utilized probability weighted rate paths to project catch-up amounts for the years 2000 to 2003, using the five interest rate scenarios, but instead modified the up and down 1 and 2 standard deviation movements to be a consistent basis point magnitude of +/- 60bps and +/- 120 bps respectively representing a change from the Enterprise's earlier forecasting assumptions.

On May 8th 2000, another memorandum[398] from Mr. Jeff Juliane now recommended that a simple average -rather than a probability weighted mean- of the five rate paths be used. Analysis included with this memorandum provided equal weights to each of the rate scenarios. The effect of this change was to reduce slightly the estimate of positive (income) catch-up for each of the current and subsequent years.

Another memorandum dated June 21, 2000, from Mr. Jeff Juliane to Mr. Tim Howard describes the impact of an alternative estimation method known as mean reversion. Mean reversion is a statistical term to describe, in this instance, a tendency that interest rates in the +/- 120bp 'shock' scenarios would trend back or revert to a "rolling five year average." This assumption had an additional modest impact to reduce the estimate of positive (income) catch-up over the forecast horizon to December 2003. In the memorandum, Mr. Juliane noted the following:

> It is worth noting that the mean catch-up difference between the Freddie[399] mean reversion technique and our standard sensitivity methodology is not that large, $61.1 million at December 2003. This is due to the natural hedge that is occurring between our core book of business and the REMIC and GFEE books of business. [400]

Still another memorandum,[401] dated September 15, 2000, from Ms. Janet Pennewell to Mr. Tim Howard provided another analysis of estimated catch-up over a forecast horizon through to December 2003. This analysis showed an even larger decrease in the estimate of positive (income) catch-up through to 2003, of approximately $261.4 million over the June 21, 2000 analysis. This analysis differed from previous ones in that the use of short-term constant

[397] Memorandum from Mr. Jeff Juliane to Ms. Leanne Spencer, dated April 5, 2000, Subject: Amortization Sensitivities, FMSE-SP 000236 – 000238.
[398] Memorandum from Mr. Jeff Juliane to distribution, dated May 8, 2000, Subject: Amortization/Catch-up Management Process, FMSE 217527 to FMSE 217531. The distribution list includes Mr. Tom Lawler, Ms. Leanne Spencer, and Mr. Rene LeRouzes.
[399] This was referred to as the "Freddie Method" because the Enterprise had understood it to be the methodology employed by Freddie Mac. OFHEO's procedures did not extend to determining if this method was ever employed by Freddie Mac
[400] Memorandum from Mr. Jeff Juliane to Mr. Tim Howard, dated June 21, 2000, Subject; Amortization Policy Runs, FMSE 217521 – FMSE 217526.
[401] Memorandum from Ms. Janet Pennewell to Mr. Tim Howard, dated September 15, 2000, Subject: Amortization Policy, FMSE-SP 000016 to FMSE-SP 000028. The distribution list includes Ms. Leanne Spencer, Mr. Jeff Juliane, and Mr. Tom Lawler.

prepayment rates (CPRs) was extended from 3 months to 24 months. This had the effect of reducing the estimate of positive catch-up (income).[402]

The table below shows the progressive change in forecasted catch-up under the different methods described in the previously noted memorandum:

Date	5-Apr-00 Analysis	8-May-00 Analysis	21-Jun-00 Analysis	15-Sep-00 Analysis	Difference 4/5 to 9/15
December-00	$183.0	$179.3	$122.9	$88.8	($94.2)
December-01	$222.0	$219.0	$184.3	$125.5	($96.5)
December-02	$258.0	$255.0	$242.6	$165.1	($92.9)
December-03	$292.2	$290.7	$297.3	$206.3	($85.9)
Base rate path used	8.65%	8.65%	8.06%	8.40%	
Book used	Jan-00	Jan-00	Apr-00	May-00	
Reference	FMSE-SP 000237	FMSE 217529	FMSE 217523	FMSE-SP 000018	

OFHEO has concluded that the Enterprise sought to maintain a positive level of catch-up when the amortization policy was formulated in 2000. OFHEO also believes that the effort of continual iterative analysis, and subsequent choices in methodology made by Fannie Mae management, reflected a consciously determined objective to understate the amount of estimated catch-up itself to better facilitate 1) shifting income between reporting periods (from 2000 to 2001) or 2) converting earnings that would otherwise be subject to volatility to earnings that would be recognized in a more stable pattern. The contention that income was shifted from 2000 to 2001 will be demonstrated by other actions taken by management as described in Section D of the Report.

The methodological choice to migrate from a probabilistically determined mean catch-up to one determined by calculating a simple mean is not grounded in any sound statistical or finance theory. Moreover, calculating a simple mean did not reduce the effort or complexity of estimating the catch-up in any meaningful way. Furthermore, while modifying the up and down rate paths - so that they were equal in their basis point magnitude - is a defensible simplifying accounting convention; it is clear that the Enterprise had a previously established view on, as well as capability to support, what management previously regarded as better practice. Third, while mean reversion was not incorporated as a standard convention of the Enterprise's estimation methodology, management nevertheless adopted – as part of the December 2000 policy – the ability to use a different rate path. This flexibility extended to choosing not only the level of interest rates used in the base rate path, but also other assumptions regarding interest rate behavior. The manifestation of this flexibility included assumptions made by management – in the estimate of Q2 2003 deferred price amortization - regarding their expectation that interest rates would rise from historic lows back to higher levels. In this

[402] Untitled, undated document from Mr. Tim Howard to Ms. Janet Pennewell labeled "Notes for Janet" states "Lost $78 million in catch up due to methodology change (short term CPR's were changed from 3 months to 24 months) to slow down the recognition of discount into income in request to reducing the positive catch-up and transferring income into outer years." FMSE-SP 002590

instance, the employment of this discretionary assumption allowed management to increase income in a measured way. The ability to exercise such judgment in determining rate paths was even better than mean reversion because it could be employed at the discretion of management.

C. Use of Multiple Rate Paths

Beyond the specific assumptions used to develop the multiple rate paths, the use of multiple rate paths *itself* had two further significant effects on the estimate of deferred price amortization:

1. Fannie Mae was generally asymmetrically exposed to changes in interest rates insofar as the income statement impact of deferred price adjustment amortization was concerned. Asymmetrical exposure means that the financial impact to the Enterprise of interest rate movements in one direction is greater than the impact of rate movements of similar magnitude in the other direction. In 2000, and for most other subsequent periods, downward movements in interest rates affected the Enterprise's net income greater than upward movements of similar magnitude. This effect is illustrated by the following analysis of data taken from the sensitivity modeling results for the forecast of December 2000 catch-up included in the September 15, 2000 memorandum:

Rate Path Scenario	Estimated Catch-up	Deviation From Base
Up 120 bps - 9.6%	$139.9	$18.5
Base - 8.40%	$121.4	-
Down 120 bps - 7.2%	($2.5)	($123.9)

Source: Memorandum from Ms. Janet Pennewell to Mr. Tim Howard, dtd 9/15/200, FMSE-SP 000018

As can be seen from the above analysis, the income statement impact of $123.9 million in expense of the down 120bps scenario is much more dramatic than the $18.5 million income statement impact to income of the up 120bps scenario. This asymmetrical effect of interest rate moves on deferred price adjustment amortization was consistent with the Enterprise's typical portfolio profile. This effect and profile was well understood by management.[403]

[403] An undated memorandum titled "Suggested Amortization Strategy" states the following: "On the second issue, I would recommend that the desired level of the catchup at any given time be equal to the average of the "up 120bp" catchup estimate, the "down 120 bp" catchup estimate, and the "base" catchup estimate, assuming the base catchup estimate were zero. Given the asymmetric nature of our catchup – the catchup usually becomes more negative when rates go down that [sic than] it becomes positive when rates go up, following the asymmetric response of prepayments to changes in interest rates – this recommendation would imply that our target catchup level will usually be somewhat positive." The memorandum also contains handwritten notes indicating "from Tom April 00," which was confirmed by testimony provided by Mr. Tim Howard to be referring to Mr. Tom Lawler. FMSE 217556-217557

The consequence of using multiple rate paths to determine an estimate of average catch-up was that the estimated amount of catch-up would be lower (during this time period) than if just the base rate path was used. The analysis below, using Fannie Mae sensitivity modeling for the forecast of December 2000 catch-up included in the various memoranda referenced previously, illustrates this effect further.

Rate Path Scenario	5-Apr-00 Analysis	8-May-00 Analysis	21-Sep-00 Analysis
Base Path - Est. Catch-up	$160.1	$160.1	$96.2
Mean - Est. Catch-up	$146.1	$142.3	$70.1
Difference	($14.0)	($17.8)	($26.1)
Method Applied	Weighted Avg.	Simple Avg.	Simple Avg.
Reference:	FMSE-SP 000237	FMSE-217529	FMSE-SP 000018

In her testimony cited previously, Ms. Pennewell explained the rationale for using multiple rate paths:

> Anyway, so, in order to produce a good set of factors we needed a model that didn't just, say, give me one interest rate path and produce one set of factors. We needed the ability to, as I said, capture a range of assumptions and adjust the factors to reflect that range of assumptions.[404]

In fact, however, Fannie Mae *did not* use the multiple rate paths to establish the prospective estimated life over which deferred price adjustments would be amortized. Mr. Jeff Juliane confirmed this in his testimony:

> Q: Would the – I think – you testified earlier the base scenario would be the one that would be used for the factor change that would occur the month after the quarter end? Is that correct?
> A: That's correct.[405]

In later testimony during that same interview:

[404] OFHEO Interview, Ms. Janet Pennewell, June 15, 2004, p. 24
[405] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 141-142
Q: I think you justified [sic. testified] earlier that the base-rate scenario would be the one that would be used for the factor change that would occur the month after the quarter end; is that correct?
A: That is correct.

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Q: So the question I have is what impact would the multiple scenarios have on the factors used to amortize premium and discount balances going forward?
A: Can I ask you back what I think you're asking?
Q: Uh-huh.
A: Are you asking, to the extent what are the nonbase runs, how do those nonbase runs impact the factors?
Q: Going forward, yes.
A: Currently, they don't.
Q: So, if the multiple scenarios are based upon the uncertainty of future interest rates, but they really don't affect the amortization in the future, then what is the multiple scenarios used for?
A: Let me step back. They impact the prospective recognition of amortization to the extent that the five runs lead us to be outside of compliance with policy and take an on-top. We also have identified this as a requirement in our current rebuild of the AIMS system, so we are now – I don't know if you guys have heard this yet, we are getting re-engineered right now, and we're going to have a system called MARS, Modeling And Reporting System. And when we do rate changes, it's going to be based upon all five scenarios.
It was an operational implementation thing that we couldn't do it when we went with AIMS. It was something that we discussed, but we couldn't operationally implement it when AIMS went live.[406]

The multiple rate scenarios of future interest rates, therefore, only impacted the retrospective (historical) element of the amounts required to be recognized by SFAS 91. Effectively, Fannie Mae was applying different estimated lives in the calculation of deferred price adjustment amortization. One set of estimated lives – based upon a methodology that resulted in lower estimates of catch-up than the base rate path would have suggested – for the determination of the current quarter's retrospective adjustment, and another set of estimated lives – based solely upon the base rate path – for the determination of the rate of prospective amortization.

2. The use of the multiple rate paths also had the effect of *reducing* the volatility of the retrospective adjustment required under SFAS No. 91. This effect is demonstrated in the graphs provided in the section titled "Historical Analysis of Accounting for Deferred Price Amortization." The reason for this is that the change in quarterly catch-up, from period to period, is going to be greater if that change is based upon fluctuations in one rate path, versus the fluctuation in multiple rate paths that are averaged together. When five rate paths are averaged, the resultant impact from change to one rate path is likely to be partially offset from the resultant impact of change to a different rate path. In that regard, deferred price adjustment amortization - using a multiple rate path estimation method – is going to be less affected by fluctuations in rates, than it will be by sustained upward or downward trends in rates.

The behavior of results produced by the Enterprise's method for estimating deferred price adjustment amortization was also understood by management. Mr. Tim Howard commented on this:[407]

[406] OFHEO Interview, Mr. Jeff Juliane, August 31, 2004, pp. 144-145.

Q: Do you have a sense for how frequently the modeled estimate would exceed a plus or minus 1-percent threshold?
A: The modeled estimate? The calculated catch-up amount?
Q: Yes.
A: No, I don't. It will do that when interest rates are trending more often than when they're simply volatile at random-

OFHEO has concluded that the use of multiple rate paths facilitated the shifting of income from 2000 to 2001 and also served to reduce the volatility of the current quarter's retrospective adjustment of deferred price adjustment amortization for all reporting periods.

D. The Application of Estimation Methods in 1999 and 2000

OFHEO's conclusion that Fannie Mae management purposefully selected methods to understate the estimate of catch-up for prospective periods is corroborated by the Enterprise's actions in applying estimation methods during the time frame coincident with the development of those methods.

Except where specifically noted otherwise, the following information[408] was provided to OFHEO by Fannie Mae. In addition, certain information has been specifically highlighted (circled) and referenced.

[407] OFHEO Interview, Mr. Tim Howard, August 5, 2004, pp. 158-159.
[408] Document titled "Fannie Mae PDA Catch-Up." Typed notation indicates "Forwarded to Peat on 10/06/00." Handwritten notation indicates "to KPMG 10/6/00." FMSE-SP 002434

Period	PDAMS	REMICS	Unapplied On-Tops	Corporate Total	Fannie Mae Current Coupon	30 Yr Fixed Rate Mortgage	FRM CPR Based on	Basis Point Difference[2]
Dec-98	(178.2)	(298.0)	276.5	(199.7)				
Jan-99	(76.7)	(74.5)	17.9	(133.3)	6.28	6.79	6.75	0.04
Feb-99	(95.1)	(73.0)	34.8	(133.3)	6.69	6.81	6.75	0.06
Mar-99	(66.7)	(78.7)	32.5	(112.9)	6.64	7.04	7.00	0.04
Apr-99	(69.0)	(81.3)	46.6	(103.7)	6.66	6.92	7.00	(0.08)
May-99	(73.9)	(81.3)	60.5	(94.7)	6.99	7.15	7.00	0.15
Jun-99	(53.7)	(144.6) a	66.7	(131.6)	7.21	7.55	7.25	0.30
Jul-99	(55.7)	(142.5)	75.9	(122.3)	7.52	7.63	7.25	0.38
Aug-99	(56.3)	(121.6)	82.9	(95.0)	7.69	7.88	7.25	0.63
Sep-99	2.5	(68.5)	88.9	22.9	7.45	7.90	7.90 b	0.00
Oct-99	2.6	(66.2)	99.8	36.2	7.46	7.85	7.90	(0.05)
Nov-99	4.4	(66.2)	121.9	60.1	7.60	7.74	7.90	(0.16)
Dec-99	6.7	(59.0)	136.3	84.0	7.80	7.91	7.90	0.01
								0.00
Jan-00	(14.6)	(48.0)	127.6	65.0	8.10	8.21	8.05	0.16
Feb-00	(20.4)	(48.0)	127.6	59.2	8.01	8.33	8.05	0.28
Mar-00	(20.0)	23.6 c	127.6	131.2	7.96	8.24	8.05	0.19
Apr-00	(44.9)	60.7	119.7	135.5	8.08	8.15	9.00 d	(0.85)
May-00	(46.0)	64.8	111.9	130.7	8.24	8.45	9.00 e	(0.55)
Jun-00	(59.2)	48.0	104.1	92.9	7.92	8.52	8.40 f	0.12
Jul-00[3]	(56.5)	57.0	96.3	96.8	7.94	8.29	8.40	(0.11)

1 source: www.ubs.com
2 Computed by determining the difference between the rate provided in the column labeled '30 Yr Fixed Rate Mortgage' and the rate provided in the column labeled 'FRM CPR Based on'
3 Fannie Mae did not provide OFHEO with a similar analysis for periods subsequent to July 2000.

The above information provides the actual catch-up calculated historically by Fannie Mae and the related underlying interest rate assumptions. As can be seen, the relationship between 1) the interest rate upon which prepayment rates ("CPR"[409]) were based, and 2) the rate identified by the Enterprise as the 30 year fixed rate mortgage ("FRM"), is tenuous. The basis point difference between these two rates varies and, furthermore, the basis point difference is also sometimes negative and sometimes positive. In addition, it is clear that the CPR rate used for forecasting is held steadier by management than the FRM rate would otherwise suggest. Lastly, the Fannie Current Coupon Rate[410] is also provided for comparison purposes as well. Changes in the Fannie Mae Current Coupon Rate correlate more closely to the FRM rate, than the FRM rate correlate to the CPR rate. At a minimum, Fannie Mae's selection of interest rate assumptions does not seem to have been determined in a systematical and objective method.

The following is an analysis of certain specific actions that Fannie Mae management took with regard to setting the CPR rate. It should be understood, however, that OFHEO is conducting further review of the catch-up estimation rate setting process for periods both before and after 1999 and 2000.

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[409] CPR stands for Constant Prepayment Rate.
[410] The pass-through coupon in the mortgage-backed securities (MBS) market trading at or nearest to - but not exceeding - par.

June '99 (Note a): In June of 1999, the Enterprise had increased the percent of the REMIC book which could be modeled to support the calculation of the constant effective yield required under SFAS No. 91. However, the modeling of a greater portion of the REMIC book had had an adverse impact on the catch-up. According to a memorandum[411] dated July 15, 1999, the incremental impact on the catch-up of the additional REMIC's was approximately $72.5 million additional expense. When all other factors are considered, including a rate change from 7.00% to 7.25%, the negative catch-up associated with the REMIC book increased by $63.3 million. This brought the estimate of the total negative catch-up back over $100 million to negative $131.6 million.

September '99 (Note b): Three months later, the Enterprise's catch-up had swung from the negative $131.6 million to a positive catch-up of $22.9 million – a large swing of $154.5 million of unrecognized positive income. $21 million[412] of this swing can be accounted for by the modeling of additional REMICS. The remainder of the increase is due to the 'in-use'[413] rate change from 7.25% to 7.90%.

As previously noted, it is difficult to draw precise conclusions from the relationship between 30 year fixed mortgage rate and the 'in use' rate used to estimate prepayments. On the one hand, the change between the August versus the September 30 year mortgage rate was only 2 basis points. On the other hand, the 30 year fixed mortgage rate had in fact risen 86 basis points since March 1999, when the 'in use rate' was at 7.00%. However, a memorandum[414] from Mr. Jeff Juliane, dated one month before the September 2000 catch-up estimate was prepared, provides his perspective on the rate change:

> In the upcoming month, we will be initiating a rate change from our current 7.25% level to our Q3 Forecasted Rate Path of 7.90%. We would expect the quarterly change and subsequent slowdown in prepayment speeds to allow for further earnings flexibility and a subsequent improvement in the near term.

March '00 (Note c): The estimated catch-up for March '00 was determined in April '00. A memorandum[415] from Mr. Jeff Juliane to Ms. Leanne Spencer, dated April 5, 2000, states that:

> "The Q1 sensitivities include the impact of process enhancements for REMICs, which now support the modeling of approximately 93% of the underlying book. This added approximately $63.5 million additional catch-up income, and an average catch-up improvement of $30.1 million throughout the forecast horizon."

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[411] Memorandum from Mr. Jeff Juliane/ Rene LeRouzes to distribution, dated July 15, 1999, Subject: PDAMS/REMIC Results (May Book). Distribution included Ms. Janet Pennewell. FMSE-SP 003089 – FMSE-SP 003092

[412] Memorandum from Jeff Juliane/Rene LeRouzes to distribution, dated October 15, 1999, Subject: PDAMS/REMIC Results (August Book), distribution included Ms. Janet Pennewell. FMSE-SP 000328

[413] 'In-use rate' is a Fannie Mae term that refers to the rate being used to estimate prepayments.

[414] Document titled 'Fannie Mae PDA Catch-up'. Typed notation indicates forwarded to Peat on 10/06/00. Handwritten notation indicates "to KPMG 10/6/00." FMSE-SP 002434

[415] Memorandum from Jeff Juliane/Rene LeRouzes to distribution, dated October 15, 1999, Subject: PDAMS/REMIC Results (August Book), distribution included Ms. Janet Pennewell, FMSE-SP 000327-000330

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The modeling of the additional REMICS also had the effect of increasing the March 2000 catch-up to a positive (income) $131.2 million – above the informal pre-policy catch-up threshold.[416] The impact on estimated catch-up for prospective years is demonstrated on two schedules of sensitivity analysis that were attached to the April 5, 2000 memorandum.[417] The first schedule shows the Year 2000 sensitivity analysis using the January book with 93% REMICS modeled, while the second schedule shows the Year 2000 sensitivity analysis using the previous October book with 76% REMICS modeled. A comparison between these two schedules shows the average catch-up improvement $30.1 million throughout the forecast horizon associated with the increased REMIC modeling, as well as an additional increase in catch-up due to the increasing rate environment:

Date	5-Apr-00 76% Remics	5-Apr-00 93% Remics	Difference
Dec-00	$115.5	$183.0	$67.5
Dec-01	$168.2	$222.0	$53.8
Dec-02	$215.8	$258.0	$42.2
Dec-03	$261.2	$292.2	$31.0
Base rate path used	8.05%	8.65%	
Book used	Oct-00	Jan-00	
Reference	FMSE-SP 000237	FMSE-SP 000238	

Recall that at the end of 1998 Fannie Mae was confronted with the challenge of a larger than anticipated estimated current loss, of which approximately $200 million was deferred to subsequent periods. The situation now presenting itself to the Enterprise was the circumstance of a large unrecognized current period income, along with the expectation of greater forecasted unrecognized income (positive catch-up) over its planning horizon.

Coincidentally, the analysis in the April 5th memorandum[418] was also the analysis whereby Fannie Mae changed its proposed catch-up estimation method to utilize up and down rate paths of similar magnitude. Had this change in estimation method not been made, the forecast of future positive catch-up would have been even greater.

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[416] OFHEO Interview, Ms. Leanne Spencer, June 22, 2004, p. 61
Q: You said before there was roughly a hundred million dollar threshold.
A: I said that previously in when we were talking about inherent limitations of the model, what the model could do and couldn't do, that our auditors understood those limitations, and that it was an unwritten policy that was not documented, but it was an established practice we had in operating on our auditors that a plus or minus 100 million represented the acknowledgement of the imprecision that exists in this estimation process in connection with our model.

[417] *Id.*, memorandum from Mr. Jeff Juliane to Ms. Leanne Spencer, dated April 5, 2000, Subject: Amortization Sensitivities. FMSE-SP 000236–000238.

[418] *Id.*, FMSE-SP 000237.

April '00 (Note d): The estimated catch-up for April '00 was determined in May '00. A memorandum[419] from Jeff Juliane, dated May 23, 2000, notes that "Management has determined to implement a rate change with the April Book." If the challenge however was large unrecognized income and large estimates of forecasted catch-up raising the 'in use' rate would seem to make these challenges larger. One factor, that offset the effect of increase in the base rate, was a change in the book. This offsetting impact as well as the change to the book was highlighted in an undated document titled 'Notes for Janet – Explanation of results' in a section of the document referencing a rate change from 8.05% to 9.0%, it states:

> Picked up $75 million in catch-up due to rate change and lost $30 million in catch-up due to change in book (recognizing too much discount into income). The amount of discount added from October of 1999 through April of 2000 was $1.4 billion dollars.[420]

Further mitigating the impact – on both current period as well as forecasted prospective catch-up - of the decision to increase the 'in use' rate, was another decision, also reflected in the May 23rd memorandum, to recognize $54.3 million of income. This had the effect of reducing both the current period catch-up as well as the forecasted catch-up.

Lastly, also coincident with the decision to raise rates, was the further decision – reflected in the May 8th memorandum[421] - to use an un-weighted simple average rather than a probabilistically weighted mean of the multiple rate paths.

May '00 (Note e): The estimated catch-up for May '00 was determined in June '00. A memorandum[422] dated June 16th from Rene LeRouzes highlights managements decision to recognize still more income. The memorandum states: "the Q2 sensitivities include $15.7 million of applied on-tops (GFEE: $3.7 million, NII: $12.0 million) booked as of May." Accordingly, another memorandum,[423] dated June 26th provides a catch-up summary analysis showing the reduction of $70 million ($54.3 million from ***note d***, plus $15.7 million as indicated in this note) from both the current period as well as the forecasted catch-up. However, the catch-up May '00 remains at $130.7 million, well in excess of the $100 million mark.

June '00 (Note f): The estimated catch-up for June '00 was determined in July '00. The challenge of too high a level of forecasted catch-up in subsequent years continued to be

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[419] Memorandum from Mr. Jeff Juliane/ Mr. Rene LeRouzes to distribution, dated May 23, 2000, Subject: PDAMS/REMIC Results (March Book), FMSE-SP 000299 to FMSE-SP 000302. Distribution includes Ms. Janet Pennewell.

[420] Undated document titled: Notes for Janet – Explanation of results. This document was provided to OFHEO by Ms. Janet Pennewell, pursuant to OFHEO's subpoena for information issued to her. The full reference indicated reads; 'Picked up $75 million in catch-up due to rate change and lost $30 million in catch-up due to change in book (recognizing too much discount into income). The amount of discount added from October of 1999 through April of 2000 was $1.4 billion dollars.' FMSE-SP 002590

[421] Memorandum from Mr. Jeff Julianne to distribution, dated May 8, 2000, Subject: Amortization/Catch-up Management Process, FMSE 217527 to FMSE 217531. Distribution includes Mr. Tom Lawler, Ms. Leanne Spencer, and Mr. Rene LeRouzes.

[422] Memorandum from Rene LeRouzes to distribution, dated June 16, 2000, Subject; Q2-2000 Catch-up Sensitivities. Distribution included Mr. Tim Howard, Mr. Tom Lawler, Ms. Leanne Spencer and Ms. Janet Pennewell. FMSE-SP 002608-002609.

[423] Memorandum from Mr. Jeff Juliane/Mr. Rene LeRouzes to distribution, dated June 26, 2000, Subject; PDA/REMIC Results (April Book). Distribution includes Ms. Janet Pennewell. FMSE-SP 002611-002612.

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addressed in earnest. Analysis prepared on July 10th contrasts one scenario with a 9.00% 'in use' base rate path, and a flat rate curve,[424] with another scenario that used a 8.40% 'in use' base rate path, and a curve that used lower short-term interest rates for the first 24 months of the rate curve. The difference between these two methodologies was significant:

Date	Q2 2000 Version 1	Q2 2000 Version 2	Difference
Dec-00	$155.2	$88.8	($66.40)
Dec-01	$198.8	$125.8	($73.00)
Dec-02	$238.1	$165.1	($73.00)
Dec-03	$275.1	$206.3	($68.80)
Method	Mtg rate flat	24 mos. Sht term rates	
Base rate path used	9.00%	8.40%	
Book used	April '00 Book	May '00 Book	
Reference	*FMSE-SP 002822*	*FMSE-SP 002591*	

The estimation method using short-term rates for the first 24 months of the rate curve had the effect of reducing the estimate of unrecognized income for all prospective periods. This estimation method was also the method formally recommended by the working group to Tim Howard in the memorandum[425] dated September 15, 2000. Furthermore, Fannie Mae in fact also changed the 'in use' base rate path for the estimation of the June '00 catch-up from 9.00% to 8.40%. In addition to lowering the forecast of catch-up for prospective years, the change also addressed the other challenge of high (above 100 million) current period catch-up. Accordingly, the quarterly catch-up decreased approximately $38 million to $92.9 million.

Although it is somewhat difficult to evaluate, the decision to lower the base rate path by 60 basis points to 8.40%, seems to be too large a decrease to be explained by the interest rate environment alone. Fannie Mae's own analysis of catch-up and 'in use' rates used to determine prepayments, shows that 30 year fixed mortgage rates in fact *rose* to 8.52% from 8.45%. Alternatively, OFHEO's analysis of interest rates shows that rates did indeed decline, but not by enough to justify the full amount of the decrease. OFHEO's analysis shows that the 10 year treasury and Fannie Mae Current Coupon declined by only 32bps and 34bps respectively.

Perhaps the rationale for both the change in estimation method as well as the decline in the 'in use' base rate path is also provided by the undated document[426] titled 'Notes for Janet – Explanation of results.' In a different section of the document referencing a rate change from 9.0% to 8.4% it states:

[424] Fannie Mae's catch-up estimation method heretofore utilized a flat rate curve.
[425] Memorandum from Ms. Janet Pennewell to Mr. Tim Howard, dated September 15, 2000, Subject: Amortization Policy, FMSE-SP 000016-000028. Distribution includes Ms. Leanne Spencer, Mr. Jeff Juliane, and Mr. Tom Lawler.
[426] Undated document titled: Notes for Janet – Explanation of results. FMSE-SP 002590

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Lost $20 million in catch-up due to rate change and picked up $30 million in catch-up due to change in book (recognizing to little discount into income). Lost $78 million in catch up due to methodology change (short term CPR's were changed from 3-months to 24-month) to slow down the recognition of discount into income in request to reducing the positive catch-up and transferring income into the outer years.

E. Conclusion

Fannie Mae's formulation, selection and application of estimation methods seems to have been made for the purposes of achieving desired results rather than for achieving good faith estimates of the highest quality. Furthermore, the estimation methods were not consistently applied to both the retrospective adjustment, and prospective amortization required by SFAS 91. Lastly, the selection of market rate assumptions was not made in an objective and consistent manner. Instead, priority was given to the financial statement impact of these assumptions.

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APPENDIX II

Summary of SFAS 133, Accounting for Derivatives and Hedging Activities

The hedge accounting framework in SFAS 133 results in a matching of the earnings effect of the change in fair value (or cash flows) of the derivative and that of the hedged item, by offsetting them against one another in the same accounting period. As hedge accounting is elective, companies are able to designate a derivative as a hedging instrument at any time and apply hedge accounting prospectively as long as the related criteria are satisfied. Qualifying for hedge accounting is important to many entities because of this matching effect that it provides in the income statement.

Under SFAS 133, hedges can be classified as fair value hedges or cash flow hedges. The objective of a fair value hedge is to use a derivative to mitigate the variability in the fair value of the hedged item. In a fair value hedge, both the changes in the fair value of the hedging derivative and the changes in the fair value of the hedged item (usually an asset or a liability) attributable to changes in the risk being hedged are recorded in earnings.[427] Effectiveness for a fair value hedge is determined as the extent to which the changes in the fair value of the hedging instrument offset the changes in the fair value of the hedged item attributable to the risk being hedged. The net difference represents the hedge ineffectiveness. The objective of a cash flow hedge is to mitigate the variability of cash flows relating to a hedged item (usually a forecasted transaction) using a derivative. In a cash flow hedge, changes in the fair value of the hedging instrument are recorded in AOCI for the effective portion of the hedge, while the ineffective portion is recorded immediately in earnings. Amounts accumulated in AOCI are reclassified from AOCI to earnings in the period in which the hedged item affects earnings.[428]

Hedge accounting is permitted only if the derivative is highly effective in hedging the identified hedged risk associated with the hedged transaction at inception and throughout the term of the hedging relationship.[429] That is, in order to qualify for hedge accounting, the changes in the fair value or cash flows of a hedged item attributable to the risk being hedged must be expected to be largely offset by the related changes in the fair value of the hedging instrument. This expectation must be updated at least quarterly.[430] Additionally, a hedger is required to support its expectation by either qualitative or analytical means referred to as an effectiveness "assessment." SFAS 133 provides the hedger flexibility in identifying the methodologies used in assessing the effectiveness of these hedges; however, the methodologies selected must be reasonable and applied consistently to all similar hedges. Such methodologies must also be specified in documentation prepared at the inception of the hedge and may not be changed retroactively.

SFAS 133 recognizes that a certain level of hedge inefficiency exists in almost every hedging relationship, even those that are deemed to be highly effective. That inefficiency, referred to as hedge ineffectiveness, may result because of differences in tenors, indices, repricing dates,

[427] FASB, SFAS 133, paragraph 22.
[428] FASB, SFAS 133, paragraph 31.
[429] FASB, SFAS 133, paragraphs 20 (b) and 28 (b) for fair value and cash flow hedges.
[430] FASB, SFAS 133, paragraphs 20 (b) and 28 (b) for fair value and cash flow hedges.

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credit worthiness, liquidity, etc. between the hedging derivative and the hedged item. *To the extent hedge ineffectiveness exists, it must be measured and recorded in earnings immediately.* Thus, at least on a quarterly basis, an entity is required to measure the ineffectiveness in the hedge and report it immediately in the financial statements. SFAS 133 prescribes the methodologies that should be used to measure the ineffectiveness in hedging relationships, and such methodologies may differ from those used to assess the effectiveness of that relationship. Accounting prior to the effective date of SFAS 133 ignored hedge ineffectiveness.

In addition to the assessment test, documentation of the hedging relationship is critical to qualify for hedge accounting. As part of the hedge designation, the hedger must identify, at a minimum, the following information:[431]

- The nature of the risk being hedged and a description of the hedging instrument and the hedged item
- A description of how the hedging instrument's effectiveness in offsetting the change in fair value or cash flows will be assessed and measured
- A description of how the designated hedging relationship is consistent with the established risk management practices.

SFAS 133 requires that this information be documented concurrently with the designation of the hedge to avoid accounting abuses. Once the designation and documentation is complete for an individual hedging relationship, hedge accounting will be afforded prospectively for that specific relationship. There can be no retroactive designation of any hedging relationships.

[431] FASB, SFAS 133, paragraphs 20 (a) and 28 (a) for fair value and cash flow hedges, respectively.

APPENDIX III

Example of a Term-out Transaction

Description of Transaction:

• On 7/2/1997, Fannie Mae issues $500M in DNs and enters into Swap #1. Swap #1 is a pay-fixed, receive-floating swap with a term of 7 years, the period of expected reissuance of DNs. For purposes of this example it is assumed that the swap's interest rate reset dates match the expected timing of DN reissuance and all other critical terms are matched in order to allow Fannie Mae to assume perfect effectiveness under SFAS 133.
• On 7/2/1999, Fannie Mae issues $500M 6.175% 3-yr MTN rather than reissuing $500M in DNs. At that time Fannie Mae also enters into swap #2. Swap #2 is a receive-fixed, pay-floating swap that matures in 3 years. Swap #2 is structured such that its cash flows offset those of swap #1 for the three year term of swap #2, with the exception of a differential between the fixed rates of the two swaps, which remains constant during that period.
• Upon the maturity of the MTN, Fannie Mae expects to resume issuing $500M in DNs through the remainder of the original 7 year period.
• As of 7/2/1999, the re-designated swap #1 together with swap #2 is hedging DNs to be issued over a "forward starting" two year period that begins 7/2/2002.

Hypothetical Derivative

- Since the hedged transactions represent discount notes to be issued in a "forward starting" period, as noted above, OFHEO believes a hypothetical forward starting pay-fixed swap should be used for purposes of measuring hedge ineffectiveness based on the guidance provided in DIG Issue G7 and for assessing effectiveness using the dollar offset method.
- The forward starting swap ("hypothetical derivative") is assumed to be on market terms (such that the fair value is zero) as of 7/2/99 (the inception of the new hedging relationship), with a forward starting date of 7/2/02, and maturity date of 7/2/04, consistent with the period in which future interest payments are hedged.
- In order to measure and assess effectiveness, changes in the fair values of the hedging instruments (swap#1 and #2 combined) are compared to changes in the fair value of the hypothetical derivative.
- The terms of the two swaps and the hypothetical derivative are summarized as follows:

Swap #1		Swap #2		Hypothetical Swap #3	
Notional	500,000,000	Notional	500,000,000	Notional	500,000,000
Pay	6.7850%	Receive	6.1750%	Pay	6.6999%
Receive	LIBOR	Pay	LIBOR	Receive	LIBOR
Trade Date	6/30/1997	Trade Date	6/30/1999	Trade Date	6/30/1999
Effective	07/02/1997	Effective	07/02/1999	Effective	07/02/2002
Maturity	07/02/2004	Maturity	07/02/2002	Maturity	07/02/2004
FixPayFreq	Semi-annual	FixPayFreq	Semi-annual	FixPayFreq	Semi-annual
FltPayFreq	Quarterly	FltPayFreq	Quarterly	FltPayFreq	Quarterly

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Analysis: See Next Page for Explanatory Notes.

		A	B	C	D	E	F	G	H	I	J	K	L	M	N	O	P	Q
#	Date	Swap#1 CLEAN	Swap#2 CLEAN	A + B	Hypothetical Swap#3 CLEAN	Period Change in C	Period Change in D	E - F	E/F (period dollar offset)	Cumulative Change in Hedge (1&2)	Cumulative Change in Hypothetical Swap#3	I/J (cum. dollar offset)	Cumulative OCI	Cumulative Ineffectivenss (P&L)	Period OCI Entry	Period P&L Ineffectiveness Entry	Prior Hedge OCI Amortization	Net P&L
-	06/30/1997	0																
1	09/30/1997	(9,521,840)																
2	12/31/1997	(16,632,572)																
3	03/31/1998	(18,385,686)																
4	06/30/1998	(21,234,550)																
5	09/30/1998	(43,037,438)																
6	12/31/1998	(34,911,044)																
7	03/31/1999	(23,050,5[illegible])																
8	06/30/1999	(8,953,548)	-	(8,953,548)	-		-											
9	09/30/1999	(5,110,527)	(1,748,228)	(6,858,755)	1,411,246	2,094,793	1,411,246	683,547	148.4%	2,094,793	1,411,246	148.4%	1,411,246	683,547	1,411,246	683,547	(447,677)	235,870
10	12/31/1999	3,327,731	(7,518,361)	(4,190,629)	3,388,930	2,668,126	1,977,684	690,442	134.9%	4,762,918	3,388,930	140.5%	3,388,930	1,373,989	1,977,684	690,442	(447,677)	242,764
11	03/31/2000	8,685,601	(10,273,290)	(1,587,689)	5,320,495	2,602,940	1,931,565	671,375	134.8%	7,365,859	5,320,495	138.4%	5,320,495	2,045,364	1,931,565	671,375	(447,677)	223,698
12	06/30/2000	7,178,852	(9,422,879)	(2,244,028)	4,036,143	(656,339)	(1,284,351)	628,012	51.1%	6,709,520	4,036,143	166.2%	4,036,143	2,673,377	(1,284,351)	628,012	(447,677)	180,335
13	09/29/2000	(1,055,865)	(4,554,754)	(5,610,619)	58,410	(3,366,591)	(3,977,733)	611,143	84.6%	3,342,929	58,410	5723.2%	58,410	3,284,519	(3,977,733)	611,143	(447,677)	163,465
14	12/29/2000	(13,446,023)	1,971,108	(11,474,914)	(6,413,309)	(5,864,296)	(6,471,719)	607,423	90.6%	(2,521,367)	(6,413,309)	39.3%	(2,521,367)	-	(2,579,777)	(3,284,519)	(447,677)	(3,732,196)
15	03/30/2001	(24,658,180)	8,770,759	(15,887,421)	(11,464,170)	(4,412,507)	(5,050,861)	638,354	87.4%	(6,933,873)	(11,464,170)	60.5%	(6,933,873)	-	(4,412,507)	-	(447,677)	(447,677)
16	06/29/2001	(20,589,573)	9,656,575	(10,932,998)	(7,189,426)	4,954,423	4,274,744	679,679	115.9%	(1,979,450)	(7,189,426)	27.5%	(1,979,450)	-	4,954,423	-	(447,677)	(447,677)
17	09/28/2001	(39,108,456)	13,280,986	(25,827,470)	(22,751,233)	(14,894,472)	(15,561,807)	667,336	95.7%	(16,873,922)	(22,751,233)	74.2%	(16,873,922)	-	(14,894,472)	-	(447,677)	(447,677)
18	12/31/2001	(33,476,184)	10,365,191	(23,110,993)	(20,790,673)	2,716,477	1,960,560	755,916	138.6%	(14,157,445)	(20,790,673)	68.1%	(14,157,445)	-	2,716,477	-	(447,677)	(447,677)
19	03/29/2002	(26,870,835)	5,237,763	(21,633,072)	(20,048,41[illegible])	1,477,921	742,260	735,661	199.1%	(12,679,524)	(20,048,41[illegible])	63.2%	(12,679,524)	-	1,477,921	-	(447,677)	(447,677)
20	06/28/2002	(34,700,899)	227,618	(34,473,281)	(33,617,300)	(12,840,209)	(13,568,888)	728,679	94.6%	(25,519,733)	(33,617,300)	75.9%	(25,519,733)	-	(12,840,209)	-	(447,677)	(447,677)
21	09/30/2002	(41,285,067)	-	(41,285,067)	(40,553,564)	(6,811,786)	(6,936,263)	124,477	98.2%	(32,331,519)	(40,553,564)	79.7%	(32,331,519)	-	(6,811,786)	-	(447,677)	(447,677)
22	12/31/2002	(38,000,308)	-	(38,000,308)	(37,370,431)	3,284,759	3,183,133	101,626	103.2%	(29,046,760)	(37,370,431)	77.7%	(29,046,760)	-	3,284,759	-	(447,677)	(447,677)
23	03/31/2003	(33,405,434)	-	(33,405,434)	(32,878,576)	4,594,873	4,491,855	103,019	102.3%	(24,451,887)	(32,878,576)	74.4%	(24,451,887)	-	4,594,873	-	(447,677)	(447,677)
24	06/30/2003	(27,799,169)	-	(27,799,169)	(27,374,944)	5,606,266	5,503,632	102,634	101.9%	(18,845,621)	(27,374,944)	68.8%	(18,845,621)	-	5,606,266	-	(447,677)	(447,677)
25	09/30/2003	(20,720,113)	-	(20,720,113)	(20,401,152)	7,079,056	6,973,792	105,264	101.5%	(11,766,565)	(20,401,152)	57.7%	(11,766,565)	-	7,079,056	-	(447,677)	(447,677)
26	12/31/2003	(13,853,676)	-	(13,853,676)	(13,640,999)	6,866,437	6,760,154	106,283	101.6%	(4,900,128)	(13,640,999)	35.9%	(4,900,128)	-	6,866,437	-	(447,677)	(447,677)
27	03/31/2004	(7,096,170)	-	(7,096,170)	(6,989,183)	6,757,506	6,651,816	105,690	101.6%	1,857,378	(6,989,183)	-26.6%	-	1,857,378	4,900,128	1,857,378	(447,677)	1,409,700
28	06/30/2004	(156,247)	-	(156,247)	(153,902)	6,939,923	6,835,281	104,642	101.5%	8,797,301	(153,902)	5716.2%	-	8,797,301	-	6,939,923	(447,677)	6,492,246
29	07/02/2004	-	-	-	-	156,247	153,902	2,346	101.5%	8,953,548	-		-	8,953,548	-	156,247	0	156,247
													TOTAL P&L ==========>			8,953,548	(8,953,548)	-

Explanatory Notes:

- The columns labeled as A and B represent the fair values of the pay-fixed (swap #1) and receive-fixed swap (swap #2), respectively for each quarter-end.
- Column C represents the combined fair value of swaps #1 and #2.
- Column D reflects the fair value of the hypothetical swap for each quarter-end.
- The fair values in the analysis represent "clean" fair values. These clean fair values exclude the interest accrued on the swaps. Fair values have been calculated based on actual market rates for the dates presented.
- The columns labeled E and F represent the quarterly change in fair value for the swaps and the hypothetical swap, respectively.
- Column H represents the period-to-period[432] dollar offset ratio, provided for informational purposes. This ratio represents the change in value of the hedging instruments as a percentage of the change in value of the hedged item (represented by the hypothetical instrument) for each quarterly period. The period-to-period dollar offset ratio is one way of assessing the effectiveness[433] of the hedging relationship (another is to use cumulative dollar offset ratio, as discussed below). For purposes of assessing whether a hedge is highly effective, the ratio should be between 80%-125%. If the ratio falls outside the range, the hedge does not qualify for hedge accounting, if the period-to-period method is used.
- Columns I and J represent the cumulative change in fair value of the swaps and the hypothetical swap, respectively, since the inception of the re-designated hedge relationship (7/2/99).
- Column K represents the cumulative dollar offset ratio. This represents the change in value of the hedging instruments as a percentage of the change in value of the hedged item since the inception of the hedging relationship. As noted above, cumulative dollar offset is another way in which to assess hedge effectiveness. The DAG identifies the cumulative dollar offset method as Fannie Mae's approved method to assess hedge effectiveness. Had Fannie Mae utilized the cumulative dollar offset approach for assessing effectiveness, the swaps would have failed to qualify for hedge accounting at the end of the first quarter of the hedging relationship (9/30/99).[434] If Fannie Mae were to later attempt to qualify for hedge accounting it would need to "re-start" its cumulative calculation beginning with a new inception date. Such calculations are not presented in the example.
- Column L indicates the cumulative balance in AOCI and is adjusted to reflect the lower of the absolute cumulative changes in fair value since inception between the hypothetical swap and the actual swap.
- Column N represents the change in AOCI from quarter to quarter.

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[432] A "period" in these examples refers to a quarter.
[433] The method chosen to assess effectiveness must be elected and documented at inception of the hedging relationship per paragraph 62 of SFAS 133 and DIG Issue E8 *Hedging—General: Assessing Hedge Effectiveness Of Fair Value And Cash Flow Hedges Period-By-Period Or Cumulatively under a Dollar-Offset Approach.*
[434] Note that Fannie Mae would also have been required to perform an assessment of effectiveness at the inception of the hedge relationship. As noted, Fannie Mae's DAG specifies the use of dollar offset for its assessment test, however, it is unclear how that test is to be applied at the inception of the hedge.

- Column O represents the amount of overhedge, i.e. amount by which the periodic change in fair value of the actual swaps (column E) is greater than the periodic change in AOCI (Column N). This amount is the ineffectiveness that is recorded in P&L for the quarter.
- Column P represents the prior period AOCI amortization into earnings (the balance in AOCI relating to the funding swap prior to re-designation is amortized into earnings over the original life of the swap). For the purposes of this example, the amortization has been calculated ratably.
- Column Q is the net P&L effect that would result from these entries.
- This analysis assumes that all interest payments and accruals on the swaps would also be recorded in interest expense, consistent with Fannie Mae's method. Thus, column Q represents the net difference between OFHEO and Fannie Mae methodologies.

Implications of this Analysis:
Fannie Mae does not perform the above calculations when a term-out occurs. Instead, they account for both swaps as being perfectly effective hedges and incorrectly record the changes in fair value of the swaps in AOCI. The result of accounting for these swaps as perfectly effective hedges is that the earnings effect is reflected on an accrual basis over the lives of the swaps, avoiding any volatility arising from the changes in fair values of the swaps. The analysis OFHEO has prepared presents the entries that would also be required in addition to the accrual entries recorded under Fannie Mae's approach, if the accounting were properly applied.

The following observations can be made as a result of this analysis:

- Column Q reflects the net difference in earnings that would be recorded if ineffectiveness had been properly measured, assuming the hedge passed the effectiveness test (see point below). Note that even if the hedge were deemed highly effective, there would be periodic earnings volatility, sometime in the millions of dollars, if the proper accounting treatment were applied.
- Fannie Mae's DAG provides for an assessment of effectiveness using the dollar offset approach. The above analysis indicates that this particular swap would fail such a hedge effectiveness test and therefore not qualify for hedge accounting for at least some of the periods during the term of the hedge. This would require all changes in fair value of the derivatives to be recorded in earnings during such periods.

Conclusion:
If Fannie Mae accounted for the term-out transactions in accordance with GAAP, there would have been significant volatility in earnings caused by ineffectiveness and/or the failure of hedge relationships to qualify for hedge accounting, based on the dollar offset assessment test they define in their policy.

APPENDIX IV

Example of an Offsetting Swap

Description of Transaction:

- On 7/2/97, Fannie Mae issues $500M in DNs and enters into Swap #1. Swap #1 is a pay-fixed, receive-floating swap with a term of 7 years, the period of expected reissuance of DNs. For purposes of this example it is assumed that the swap's interest rate reset dates match the expected timing of DN reissuance and all other critical terms are matched in order to allow Fannie Mae to assume perfect effectiveness under SFAS 133.
- On 7/2/01, Fannie Mae issues a $500M 6.175% 3-yr MTN to replace rollover of $500M DN and enters into swap #2. Swap #2 is a receive-fixed, 5.202%, pay-floating swap that matures in 3 years which coincides with the maturity of the MTN and the end of the original 7 year hedge period. Swap #2 serves to completely offset the effect of swap #1 except that the two swaps have different fixed interest rates because they were entered into at different times. The net result of the two swaps is a fixed stream of cash flows over their remaining lives, representing the difference in their respective fixed rates.
- The terms of the two swaps are summarized as follows:

Swap #1			**Swap #2**	
Notional	500,000,000		Notional	500,000,000
Pay	6.7850%		Receive	5.2020%
Receive	LIBOR		Pay	LIBOR
Effective	07/02/1997		Effective	07/02/2001
Maturity	07/02/2004		Maturity	07/02/2004
FixPayFreq	Semi-annual		FixPayFreq	Semi-annual
FltPayFreq	Quarterly		FltPayFreq	Quarterly

Analysis: See Next Page for Explanatory Notes.

#	Date	A Swap#1 CLEAN	B Swap#2 CLEAN	C Period Change in Swap #1	D Period Change in Swap #2	E C + D Net P&L	F Prior Hedge OCI Amortization	G Period P&L Impact
-	06/30/1997	0						
1	09/30/1997	(9,521,840)						
2	12/31/1997	(16,632,572)						
3	03/31/1998	(18,385,686)						
4	06/30/1998	(21,234,550)						
5	09/30/1998	(43,037,438)						
6	12/31/1998	(34,911,044)						
7	03/31/1999	(23,050,566)						
8	06/30/1999	(8,953,548)						
9	09/30/1999	(5,110,527)						
10	12/31/1999	3,327,731						
11	03/31/2000	8,685,601						
12	06/30/2000	7,178,852						
13	09/29/2000	(1,055,865)						
14	12/29/2000	(13,446,023)						
15	03/30/2001	(24,658,180)						
16	06/28/2001	(21,967,722)	-					
17	09/28/2001	(39,111,008)	18,407,588	(17,143,286)	18,407,588	1,264,302	(1,830,644)	(566,342)
18	12/31/2001	(33,476,184)	14,619,596	5,634,824	(3,787,992)	1,846,832	(1,830,644)	16,188
19	03/29/2002	(26,870,835)	9,880,730	6,605,350	(4,738,865)	1,866,484	(1,830,644)	35,841
20	06/28/2002	(34,700,899)	19,321,190	(7,830,065)	9,440,460	1,610,395	(1,830,644)	(220,248)
21	09/30/2002	(41,285,067)	27,682,822	(6,584,168)	8,361,632	1,777,464	(1,830,644)	(53,180)
22	12/31/2002	(38,000,308)	26,287,794	3,284,759	(1,395,028)	1,889,731	(1,830,644)	59,088
23	03/31/2003	(33,405,434)	23,608,545	4,594,873	(2,679,250)	1,915,624	(1,830,644)	84,980
24	06/30/2003	(27,799,169)	19,910,748	5,606,266	(3,697,796)	1,908,470	(1,830,644)	77,826
25	09/30/2003	(20,720,113)	14,789,064	7,079,056	(5,121,685)	1,957,371	(1,830,644)	126,727
26	12/31/2003	(13,853,676)	9,898,954	6,866,437	(4,890,109)	1,976,328	(1,830,644)	145,684
27	03/31/2004	(7,096,170)	5,106,751	6,757,506	(4,792,204)	1,965,302	(1,830,644)	134,659
28	06/30/2004	(156,247)	112,629	6,939,923	(4,994,122)	1,945,801	(1,830,644)	115,158
29	07/02/2004	-	-	156,247	(112,629)	43,618	(21,967,722)	(43,618)
				TOTAL P&L	==========>	21,967,722		

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Explanatory Notes:

- The columns labeled as A and B represent the quarter-end clean fair values of the initial pay-fixed swap (swap #1) and the offsetting, receive-fixed swap (swap #2), respectively.
- The columns labeled C and D represent the quarterly change in fair value for swap #1 and swap #2, respectively.
- Column E represents the Net P&L from the mark-to-market of the two swaps.
- Column F represents the amortization from AOCI to earnings relating to the previously existing hedge relationship.
- Column G represents net P&L for the period after taking into account the amortization of the balance from AOCI into earnings.

Implications of this Analysis:

It is OFHEO's understanding that from a hedge accounting perspective, Fannie Mae enters into swap #2 to offset swap #1. Although there is no remaining exposure to be hedged, Fannie Mae accounts for these swaps as perfectly effective hedges. The changes in fair value for both swaps, the original pay-fixed swap and the offsetting receive-fixed swap, are recorded in AOCI. The result of accounting for these swaps as perfectly effective hedges is that the earnings effect is reflected on an accrual basis over the lives of the swaps, avoiding any volatility arising from the changes in their fair values. The analysis OFHEO has prepared presents the entries that would also be required in addition to the accrual entries recorded under Fannie Mae's approach, if the accounting were properly applied.

The following observation is made as a result of this analysis:

- Column G reflects the net difference in earnings that would be recorded if the proper accounting were applied.

Conclusion:

If, after the execution of the offsetting swap, Fannie Mae had accounted for the pay-fixed swap and the offsetting receive swap in accordance with GAAP and recorded the changes in fair value of the swaps in earnings, it would have resulted in volatility in earnings.

APPENDIX V

Example of a Cancelable Swap

Description of Transaction:

• On 7/2/1997, Fannie Mae issues $500M in DNs and enters into Swap #1. Swap #1 is a pay-fixed, receive-floating swap with a term of 7 years, the period of expected reissuance of DNs. For purposes of this example it is assumed that the swap's interest rate reset dates match the expected timing of DN reissuance and all other critical terms are matched in order to allow Fannie Mae to assume perfect effectiveness under SFAS 133.

Hypothetical Derivative

- Since the hedged transactions represent discount notes to be issued over a seven year period, OFHEO believes a seven year hypothetical non-cancelable swap should be used for purposes of measuring hedge ineffectiveness based on the guidance provided in DIG Issue G7, and for assessing effectiveness using the dollar offset method. [435]
- The hypothetical non-cancelable swap is assumed to be on market terms (such that the fair value is zero) as of 7/2/97 (the inception of the new hedging relationship), with a start date of 7/2/97, and maturity date of 7/2/04, consistent with the period over which the discount note issuances are hedged.
- In order to measure and assess effectiveness, changes in the fair values of the hedging instrument (swap#1) is compared to changes in the fair value of the hypothetical derivative.

Swap #1			**Swap #2 (Non-Callable Hypothetical)**	
Notional	500,000,000		Notional	500,000,000
Pay	7.1031%		Pay	6.7850%
Receive	LIBOR		Receive	LIBOR
Effective	07/02/1997		Effective	07/02/1997
Maturity	07/02/2004		Maturity	07/02/2004
FixPayFreq	Semi-annual		FixPayFreq	Semi-annual
FltPayFreq	Quarterly		FltPayFreq	Quarterly
Callable On	07/02/2001		Callable On	n/a

[435] Fannie Mae has elected not to separate the time and intrinsic value components of the callable swap and has not identified optionality in the transaction being hedged. As such, the hypothetical is a swap with no option feature.

Analysis: See Next Page for Explanatory Notes.

#	Date	A Swap#1 CLEAN	B Swap#2 CLEAN	C Period Change in Swap #1	D Period Change in Swap#2	E C/D (period dollar offset)	F G/H (cumulative dollar offset)	G Cumulative OCI	H Period OCI Entry	I Period P&L Ineffect-iveness Entry
-	06/30/1997	(0)	0							
1	09/30/1997	(6,856,921)	(9,521,840)	(6,856,921)	(9,521,840)	72.0%	72.0%	(6,856,921)	(6,856,921)	0
2	12/31/1997	(11,312,269)	(16,632,572)	(4,455,348)	(7,110,733)	62.7%	68.0%	(11,312,269)	(4,455,348)	-
3	03/31/1998	(12,815,287)	(18,385,686)	(1,503,018)	(1,753,114)	85.7%	69.7%	(12,815,287)	(1,503,018)	-
4	06/30/1998	(14,271,875)	(21,234,550)	(1,456,588)	(2,848,864)	51.1%	67.2%	(14,271,875)	(1,456,588)	-
5	09/30/1998	(28,200,079)	(43,037,438)	(13,928,204)	(21,802,888)	63.9%	65.5%	(28,200,079)	(13,928,204)	-
6	12/31/1998	(20,280,281)	(34,911,044)	7,919,798	8,126,394	97.5%	58.1%	(20,280,281)	7,919,798	-
7	03/31/1999	(14,169,710)	(23,050,566)	6,110,571	11,860,477	51.5%	61.5%	(14,169,710)	6,110,571	-
8	06/30/1999	(5,146,137)	(8,953,548)	9,023,573	14,097,018	64.0%	57.5%	(5,146,137)	9,023,573	-
9	09/30/1999	(2,308,078)	(5,110,527)	2,838,060	3,843,021	73.8%	45.2%	(2,308,078)	2,838,060	-
10	12/31/1999	3,698,686	3,327,731	6,006,764	8,438,258	71.2%	111.1%	3,327,731	5,635,809	370,955
11	03/31/2000	6,931,412	8,685,601	3,232,725	5,357,870	60.3%	79.8%	6,931,412	3,603,680	(370,955)
12	06/30/2000	5,854,847	7,178,852	(1,076,564)	(1,506,749)	71.4%	81.6%	5,854,847	(1,076,564)	-
13	09/29/2000	1,217,927	(1,055,865)	(4,636,920)	(8,234,716)	56.3%	-115.3%	-	(5,854,847)	1,217,927
14	12/29/2000	(1,732,822)	(13,446,023)	(2,950,749)	(12,390,158)	23.8%	12.9%	(1,732,822)	(1,732,822)	(1,217,927)
15	03/30/2001	(2,498,793)	(24,658,180)	(765,971)	(11,212,158)	6.8%	10.1%	(2,498,793)	(765,971)	-
16	06/29/2001	(175,990)	(20,469,902)	2,322,803	4,188,279	55.5%	0.9%	(175,990)	2,322,803	-

Assume swap is canceled as the option was in the money

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Explanatory Notes:

- The columns labeled as A and B represent the quarterly clean fair values of the actual and hypothetical swap, respectively.
- The hypothetical swap is created to mirror the terms of the discount notes being hedged. The clean value excludes the interest accrued on the swaps.
- The columns labeled C and D represent the quarterly change in fair value for swap #1 and swap #2, respectively.
- Column E represents the period-to-period dollar offset ratio; provided for informational purposes.
- Column F represents the cumulative dollar offset ratio. The dollar offset ratio is a measure of the degree to which a hedging instrument (callable swap) has been effective in offsetting the change in fair value of the hedged item (discount notes, represented by the hypothetical swap). For purposes of assessing whether a hedge is highly effective, the ratio should be between 80%-125%. If the ratio falls outside the range, the hedge does not qualify for hedge accounting. The DAG identifies the cumulative dollar offset method as Fannie Mae's approved method to assess hedge effectiveness. Had Fannie Mae utilized the cumulative dollar offset approach for assessing effectiveness, the swaps would have failed to qualify for hedge accounting at the end of the first quarter of the hedging relationship (9/30/97).[436] If Fannie Mae were to later attempt to qualify for hedge accounting it would need to "re-start" its cumulative calculation beginning with a new inception date. Such calculations are not presented in the example.
- Column G indicates the cumulative balance in AOCI and is adjusted to reflect the lower of the absolute cumulative changes in fair value since inception between the hypothetical and the actual swap.
- Column H represents the change in AOCI from quarter to quarter.
- Column I represents the amount of overhedge, i.e. amount by which the periodic change in fair value of the actual swap (column C) is greater than the periodic change in AOCI (column H).
- Fannie Mae does not perform the above calculation and assumes that the entire change in fair value should be posted to AOCI.

Implications of this Analysis:

Fannie Mae does not perform the above calculations when executing a callable swap to hedge discount notes from a hedge accounting perspective. Instead, they account for the callable swap as being "perfectly effective" and incorrectly record the changes in fair value of the swap in AOCI. The result of accounting for the swap as perfectly effective is that the earnings effect is reflected on an accrual basis over the life of the swap, avoiding any volatility arising from the changes in fair values of the swaps. The analysis OFHEO has prepared presents the entries that would also be required in addition to the accrual entries recorded under Fannie Mae's approach, if the accounting were properly applied.

The following observations can be made as a result of this analysis:

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[436] Note that Fannie Mae would also have been required to perform an assessment of effectiveness at the inception of the hedge relationship. As noted, Fannie Mae's DAG specifies the use of dollar offset for its assessment test, however, it is unclear how that test is to be applied at the inception of the hedge.

- Column I reflects the net difference in earnings that would be recorded if ineffectiveness had been properly measured, assuming the hedge passed the effectiveness test (see poin below). Note that even if the hedge were deemed highly effective, there would be periodic earnings volatility, sometimes in the millions of dollars, if the proper accounting treatment were applied.
- Fannie Mae's DAG provides for an assessment of effectiveness using the cumulative dollar offset approach. The above analysis indicates that this particular swap would fail such a hedge effectiveness test and therefore not qualify for hedge accounting for at least some of the periods during the term of the hedge. This would require all changes in fair value of the derivatives to be recorded in earnings during such periods.

Conclusion:

If Fannie Mae accounted for the callable swap as described above, which is consistent with how the hedge was designated, there would have been significant volatility in earnings caused by ineffectiveness and/or the failure of hedge relationships to qualify for hedge accounting. Had Fannie Mae designated the relationships differently, and separated the time and intrinsic value, it is possible that hedge accounting could have been achieved, though volatility would have still resulted from having recorded time value changes in earnings.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
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Office of the Director

November 10, 2004

Honorable Richard Baker
Chairman
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Baker:

Thank you again for the opportunity to testify before the Capital Markets Subcommittee on October 6, 2004 on "The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae." Set forth below are responses to questions I committed to respond to during that hearing.

Question from Ranking Minority Member Kanjorski pertaining to outside auditor difference in 1998. See discussion of this issue at pages 67 to 70 of the Official Committee Transcript, transmitted to OFHEO on October 14, 2004 ("Committee Transcript").

Answer: We conducted a review of our examination workpapers for 1998 and 1999 to determine what documents were provided to OFHEO at that time that may have contained information about the $200 million audit difference on the accounting for premium/discount amortization.

The examiners evaluated the external audit using examination procedures in place at that time, which were similar to those that had been used by other federal agencies that regulate safety and soundness of financial institutions. In 1998 and 1999, financial regulatory agencies generally assessed the external auditor's independence, scope, the completion of that scope, and the financial institutions' actions to correct deficiencies noted by the audit. If the audits noted deficiencies, examiners generally emphasized those areas in their review of the audit.

Our review shows that the examiners reviewed documents KPMG provided to the Board's Audit Committee, and these documents did not state that KPMG had cited an audit difference in the company's FAS 91 accounting methodologies. A powerpoint presentation by KPMG to the Audit Committee on February 16, 1999, specifically stated that there were "No disagreements with management." In addition, information gathered to date indicates that KPMG did not issue a management letter in 1998 or 1999 that could have stated it had an audit difference associated

with FAS 91. Prior to the enactment of Sarbanes Oxley, external auditors were not required to issue management letters.

Some documents do indicate that there were discussions between the Audit Committee and KPMG about the amortization of premiums and discounts generally, and the fourth quarter adjustment, specifically. However, those documents do not indicate a disagreement between the company and KPMG on the fourth quarter $200 million amortization adjustment. OFHEO was not aware of KPMG's audit difference until KPMG revealed that audit difference to OFHEO during the depositions of Fannie Mae employees in 2004. This matter is the subject of our ongoing review.

Question from Representative Crowley asking for references in the OFHEO Report that say the company has issued inaccurate financial statements as a result of the accounting matters raised in the Report. Representative Crowley asked that these be identified and provided to him. See pages 157 to 158 of the Committee Transcript.

Answer: The references in the OFHEO Report that Representative Crowley requested are attached.

For Representative Watt, the Director agreed to provide the Chairman and Ranking Member of this Subcommittee with a list of contacts he had with Members of Congress and the contents of those contacts for the period leading up to the time OFHEO had the meeting with the Board of Fannie Mae on September 20, 2004. Congressman Watt's request followed on questions from Congresswoman Waters. See pages 166-167 of the Committee Transcript.

Answer:
I have searched my own records and to the best of my recollection, I had no contacts with Members of Congress during the period leading up to OFHEO's meeting with the Fannie Mae Board. As I stated in my testimony, I had contacts with Members of the Subcommittee from both sides of the aisle concerning the need for sufficient funding for OFHEO's mission, including for the investigation of Fannie Mae's accounting – but those contacts took place well before the period leading up to the meeting with the Fannie Mae Board.

Please do not hesitate to contact me at 202-414-3801 should you have any further questions about these matters.

Sincerely,

Armando Falcon, Jr.
Director

Enclosure

cc: Ranking Minority Member Paul Kanjorski

INTRODUCTION AND EXECUTIVE SUMMARY

We are currently conducting a Special Examination of Fannie Mae's accounting policies, internal controls, and financial reporting processes. Although the examination is still in process, our findings to-date are serious and warrant a report at this juncture. This report details the Special Examination's concerns on the framework and conditions of Fannie Mae's accounting policies and internal controls, with a particular focus on two critical accounting areas: deferred price adjustments, and derivatives and hedging activities.

We have determined that Fannie Mae, in developing policies and practices in these critical areas, has misapplied Generally Accepted Accounting Procedures ("GAAP"), specifically *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* ("SFAS 91") and *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133"). The misapplications of GAAP are not limited occurrences, but are pervasive and are reinforced by management. **The matters detailed in this report are serious and raise concerns regarding the validity of previously reported financial results, the adequacy of regulatory capital, the quality of management supervision, and the overall safety and soundness of the Enterprise.**

The problems relating to these accounting areas differ in their specifics, but they have emerged from a culture and environment that made these problems possible. Characteristics of this culture include:

- management's desire to portray Fannie Mae as a consistent generator of stable and growing earnings;
- a dysfunctional and ineffective process for developing accounting policies;
- an operating environment that tolerated weak or non-existent internal controls;
- key person dependencies and poor segregation of duties;
- incomplete and ineffective reviews by the Office of Auditing;
- an inordinate concentration of responsibility vested with the Chief Financial Officer; and
- an executive compensation structure that rewarded management for meeting goals tied to earnings-per-share, a metric subject to manipulation by management.

The tenor of earnings management is deeply ingrained at Fannie Mae and has given rise to accounting policies and practices that emphasize effects on earnings volatility, rather than faithfulness to GAAP. A key message by Fannie Mae to the investor community is management's ability to generate stable and growing earnings. This is evidenced by Fannie Mae's annual financial reports, with their recurring graphs of steadily increasing earnings against a backdrop of volatile interest rates. Less well known, but detailed in this report, is the fact that the desire by management to minimize earnings volatility was a central organizing principle in the development of key accounting policies.

Management also emphasized the stable earnings imperative in its communications to the Fannie Mae Board of Directors. In July 2003, even as the accounting problems of Freddie Mac were publicly emerging, Fannie Mae's Chief Financial Officer, Tim Howard, made a presentation to the Board that emphasized a "stable pattern of earnings" as a requirement for Fannie Mae if it were to be perceived as a low-risk Enterprise. Mr. Howard included in this presentation a

management to hit an earnings number. Because these estimates of amortization are also used in management's analysis of net interest income sensitivity, this practice has unfavorable safety and soundness implications that go beyond financial reporting.

The Special Examination also found that the process for estimating amortization was characterized by significant control weaknesses. Many of these control weaknesses are centered on the amortization system and the process for modeling amortization factors. **These control weaknesses undermine the process of amortization to such an extent that the accuracy of premium and discount amortization is questionable.** These control weaknesses include:

- inadequate segregation of duties and key person dependencies;
- modeling multiple runs to produce desired results;
- underlying data issues, including illogical or anomalous amortization factors; and
- a lack of written procedures, supporting documentation, and poor or non-existent audit trails.

This report also details an investigation performed by the Office of Auditing into allegations of amortization accounting irregularities raised by Roger Barnes, a former employee in the Controller's Department who left Fannie Mae in November 2003, and whose cooperation was important to our examination. The Special Examination found that Mr. Barnes's allegations were substantive, and that the Office of Auditing failed to adequately investigate the problems surrounding the amortization process that he raised.

The consequences of the misapplications of GAAP and control breakdowns surrounding accounting for amortization are potentially large. The management of Fannie Mae, by recording incorrect and incomplete amounts of premium and discount amortization, has misstated interest income over many reporting periods, as well as balance sheet accounts for unamortized premiums and discounts. Also, because amortization estimates ultimately flow to individual securities, gains or losses recorded on the sale or transfer of securities in previous periods are also questionable. Fannie Mae will need to devote considerable resources to determine the full magnitude of these errors.

Accounting for Derivative Instruments and Hedging Activities (SFAS 133)

Fannie Mae adopted SFAS 133, *Accounting for Derivative Instruments and Hedging Activities,* on January 1, 2001. The standard requires that all freestanding and certain embedded derivatives be carried on the balance sheet at fair value. Changes in the fair value of a derivative are included in earnings, which gives rise to earnings volatility. However, the hedge accounting provisions of SFAS 133 provide methods for offsetting the earnings effect of a derivative with a designated hedge transaction, if the combination meets specific criteria. **Hedge accounting is optional.** To qualify, entities must maintain extensive documentation and, in many instances, perform rigorous calculations. These stringent criteria presented significant challenges to Fannie Mae, which has a large and dynamic hedging program.

Fannie Mae had a strong desire to retain the *status quo* of accrual/synthetic instrument accounting in effect before SFAS 133, because synthetic instrument accounting provided smoother accounting earnings and greater predictability of reported financial results. To this

prospectively, and did not evaluate the impact on prior periods or transactions that existed at the time the change was made.

As of December 31, 2003, the balance in AOCI reflects $12.2 billion in deferred losses relating to cash flow hedges. [243] Furthermore, carrying value adjustments of liabilities relating to fair value hedges amounted to $7.2 billion as of that date.[244] The matters noted herein with respect to improper application of hedge accounting leads OFHEO to question the validity of the amounts reflected in AOCI; as well as amounts reflected as carrying value adjustments, at any point in time since the adoption of SFAS 133. For hedges which do not qualify for hedge accounting, fair value changes should be reflected in earnings in the period in which the value change occurred, with no offset to AOCI or hedged item carrying value. Additionally, the possible reclassification of these amounts into retained earnings could have a substantial impact on Fannie Mae's compliance with its regulatory capital requirements. In order to determine the actual impact of the matters discussed herein, a substantial investment of resources and management's commitment will be required.

[243] Fannie Mae December 31, 2003 10-K, p. 80.
[244] Fannie Mae December 31, 2003 10-K, p. 146.

In OFHEO's view, Fannie Mae's change in methodology resulted from a previous oversight or an inconsistent application of accounting principles. Fannie Mae's old methodology resulted in amounts recorded in AOCI when no corresponding change had occurred in the forecasted hedged item, which is clearly inconsistent with the cash flow hedge accounting provisions of SFAS 133. The offset to the error in AOCI is a misstatement in option premium expense. Therefore, the above change should have been **treated as a correction of an error,** resulting in the correction and re-statement of prior periods' financial statements.

Fannie Mae's interpretation of the relevance of APB 20

Fannie Mae treated the above change to be similar to that of a change in a method of amortization as discussed under paragraph 23 of APB 20. They accounted for the change in accordance with the guidance in paragraph 24 of APB 20, which relates to a new method of amortization applied to newly acquired assets. Paragraph 24 states that the Enterprise should use the new method "for all additional new assets of the same class but continue to use the previous method for existing balances of previously recorded assets of that class. For that type of change in accounting principle, there is no adjustment of the type outlined in paragraphs 19-22[312], but a description of the nature of the change in method and its effect on income before extraordinary items and net income of the period of the change, together with the related per share amounts, should be disclosed."

The excerpt below from Fannie Mae's 2002 10-K sets forth Fannie Mae's disclosure of the change in methodology.

> During the fourth quarter of 2002, we refined our methodology for estimating the initial time value of interest rate caps at the date of purchase and prospectively adopted a preferred method that resulted in a $282 million pre-tax reduction in purchased options expense and increased our diluted EPS for 2002 by $.18. Under our previous valuation method, we treated the entire premium paid on purchased "at-the-money" caps as time value with no allocation to intrinsic value. Our new methodology allocates the initial purchase price to reflect the value of individual caplets, some of which are above the strike rate of the cap, which results in a higher intrinsic value and corresponding lower time value at the date of purchase. This approach is more consistent with our estimation of time value subsequent to the initial purchase date. This change does not affect the total expense that will be recorded in our income statement over the life of our caps and has no effect on our non-GAAP core business earnings measure.

[312] These paragraphs discuss the recording of a cumulative effect of a change in accounting principle, the disclosure of pro-forma effects of retroactive application, and a change in depreciation method for previously recorded assets.

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Reporting a Correction of an Error

Reporting a correction of an error in the financial statements of a prior period discovered subsequent to their issuance should be reported as a prior period adjustment (paragraph 36 of APB 20). In addition, APB 9, *Reporting the Results of Operations*, states "when comparative statements are presented, corresponding adjustments should be made of the amounts of net income (and the components thereof) and retained earnings balances (as well as of other affected balances) for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments."

Implications

The implications of treating the above change prospectively as a change in accounting rather than a correction of an error is that the earnings and OCI amounts have been misstated for the years 2001, 2002 and likely for 2003 and possibly later periods depending upon the original maturity of the cap contracts and the future periods to which the inception intrinsic value relates.

The table below has been extracted from a memorandum from Jonathan Boyles and provides some indication of the potential dollar impact.[313] However, OFHEO contends it does not provide one with an accurate measure of the quarterly impact on earnings or AOCI.

		New Methodology		Old Methodology	
Purchase Period	Purchase Premium*	Intrinsic Value*	Time Value*	Intrinsic Value*	Time Value*
2001	248.0	128.7	119.3	0	248.0
2002	1055.0	544.0	511.0	0	1055.0
*2002: Q4***	489.7	257.8	231.8	0	489.7

* *All figures in millions of dollars*

*** The New methodology was first implemented in Q4, 2002.*

Using the 2002 information presented above for discussion purposes, it appears that options were purchased prior to the fourth quarter for an initial premium of $565.3 million ($1,055 million less $489.7 million).[314] Based on the amounts listed under the column titled New Methodology, approximately $286.2 million ($544 million - $257.8 million) should have been recorded as intrinsic value and $279.2 million ($511 million - $231.8 million) should have been recorded as time value during the first three quarters of 2002. This means that when applying the Old Methodology, option premium expense was overstated by $286.2 million in the quarters when these options were purchased, and accumulated AOCI gains/losses were overstated/understated by the same amount. Interest expense would also be understated in the future periods to which the inception intrinsic value relates. The specific periods affected would need to be determined based upon the terms of the individual cap contracts.

[313] Memorandum from Jonathan Boyles to File with Distribution, Subject: Proposal to Change Fair Value Estimate of IV/TV Decompositions for Caps, January 29, 2003, FMSE 055014-055016. The table is on page 3 of the document (FMSE 055016).

[314] As stated in the table, the new methodology was implemented starting in the fourth quarter of 2002.

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achieve a desired accounting result. This is not permitted under SFAS 133. Paragraph 385 of SFAS 133 states:

> The Board decided that concurrent designation and documentation of a hedge is critical; without it, **an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result**... [Emphasis added.]

In a 2001 email from Katarina Skladony to Mona Patel, Ms. Skladony stated:

> Please note that I am going to make the below manual change in linkage for 313SWI540. The 50M link 313SWI540 – 313SWD758 was qualified for long haul method. However, in the process of effectiveness calculation Don had a problem to reach 80-120% correlation range and asked me to seek alternative linkage to 313SWI540. I found 313SWD979 reset determination dates of which and 313SWI540 meet the 7 day window requirement and thus qualify for the short cut method."[333]

This above excerpt illustrates that retroactive re-linking was being applied to hedges in order to achieve hedge accounting treatment in situations in which the hedge effectiveness criteria (through a correlation analysis) was not met. This is clearly an example of retroactive designation in order to achieve a desired accounting result and is not permitted under SFAS 133 per the reference above.

Implications

The numerous documentation issues described above appear to have serious implications for Fannie Mae's hedge accounting. Many of these matters relate to routine, commonly occurring transactions at Fannie Mae. Under SFAS 133, the lack of adequate, contemporaneous hedge designation documentation precludes a company from qualifying for hedge accounting. This has been reiterated by the SEC staff.[334] Failure to receive hedge accounting means the fair value changes for such derivatives should be recorded through the income statement without receiving any offset, or matching with, the earnings affect of the hedged item. Given the billions of dollars of mark-to-market value of Fannie Mae's derivatives and the fact that the vast majority of them are currently receiving hedge accounting, the potential impact of these documentation issues on Fannie Mae's reported financial results and regulatory capital appears to be substantial.

[333] Email from Katarina Skladony to Mona Patel and Prasad Chintamaneni with a copy to Donald Sinclair, March 5, 2001, Subject: 313SWI540 switch from long haul to short cut, FMSE 100488-100490.
[334] See reference to December 2003 speech of John James in background section of this report.

Additionally, Fannie Mae's 10-K describes the change as a prospective change to a "preferred method" [315] of accounting. However, in a memorandum written by Jonathan Boyles in 2003,[316] he refers to the matter as an inconsistency in approaches. Mr. Boyles reference to the inconsistencies in the memorandum has not been disclosed in the 10-K. In fact, the disclosure discusses a refinement in methodology[317] and makes no reference to the inconsistent application of methods, which OFHEO believes represents an accounting error.

The above analysis and discussion show that Fannie Mae has incorrectly accounted for and reported a correction of an error in its financial statements. This is yet another example of how Fannie Mae has corrected errors in their accounting for derivatives only on a prospective basis. The impact on specific periods is unclear. Further detailed information and detailed instrument-by-instrument analysis will be required to make a precise determination of the complete financial statement impact on all periods affected.

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[315] Fannie Mae December 31, 2002 annual report on form 10-K, Notes to Financial Statements, Summary of Significant Accounting Policies, Derivative Instruments and Hedging Activities, p. 113.
[316] Memorandum from Jonathan Boyles to File with Distribution, Subject: Proposal to Change Fair Value Estimate of IV/TV Decompositions for Caps, January 29, 2003, FMSE 055014-055016, in which Mr. Boyles stated, "As the dollar amount of our cap purchases has grown over time, this inconsistency in approaches has led to growing differences in our decomposition of IV/TV."
[317] Fannie Mae December 31, 2002 annual report on form 10-K, Notes to Financial Statements, Summary of Significant Accounting Policies, p. 113, states, "During the fourth quarter of 2002, we refined our methodology for estimating the initial time value of interest rate caps at the date of purchase and prospectively adopted a preferred method that resulted in a $282 million pre-tax reduction in purchased options expense and increased our diluted earnings per share for 2002 by $.18."

FANNIE MAE BOARD OF DIRECTORS WORK PLAN IN RESPONSE TO OFHEO REPORT OF SPECIAL EXAMINATION

SEPTEMBER 22, 2004

I. SPECIAL COMMITTEE

The Board of Directors has designated a Special Review Committee, composed entirely of independent directors (McLaughlin Korologos, Marron, Ashley), to take the lead in the Board's response to OFHEO's Report of Findings to Date. The Board has retained independent counsel, former Senator Warren Rudman of Paul, Weiss, Rifkind, Wharton & Garrison LLP, to serve as counsel to the committee. The firm is in the process of retaining an independent accounting firm to assist it. The Committee will also act as a compliance committee to monitor and coordinate implementation of this work plan and related reports and recommendations. The Committee will interact directly with OFHEO to address the issues raised in the Report and in this work plan.

II. ACCOUNTING

Without prejudice to the resolution of accounting issues raised in the report, the Board shall commence immediately to address the following accounting matters:

A. In addressing FAS 91, the Board shall assure that the following actions are taken:

i. The company will implement a policy for amortization of deferred price adjustments in a manner that requires the company to book the entirety of the company's modeled catch-up position on a quarterly basis, beginning in the first quarter of 2005.

ii. The company will consult with OFHEO in the implementation of these changes.

B. In addressing FAS 133, the Board shall assure that the following actions are taken:

i. Beginning in the first quarter of 2005, the company will implement long-haul accounting, where applicable, for derivative transactions for which hedge accounting has been elected.

ii. The company will develop specifications for a computer application system to support the measurement of hedge effectiveness for transactions including those in highly effective hedge relationships.

iii. The company will consult with OFHEO in the implementation of these changes to its accounting for derivative transactions.

C. Independent counsel and its independent accounting firm, reporting directly to the Special Review Committee, will immediately commence a comprehensive review of the company's accounting policies and practices, including those addressed in the report, to ensure that they accurately reflect the Board's objectives in complying with law and regulation and in overseeing the operations of Fannie Mae. Independent counsel's work plan will be provided to OFHEO. Such independent legal and accounting firms shall have full access to books, records, e-mails, staff and other needs in conducting their review and making their reports and recommendations. The Committee will report to OFHEO concerning the findings and recommendations.

D. Other Specific Board Actions

i. The Board shall review accounting policies and other corporate policies to ensure that they accurately reflect the Board's objectives in complying with law and regulation and in overseeing the operations of Fannie Mae.

ii. The Board shall ensure that the Audit Committee or other appropriate committee has at least one person with sufficient technical expertise to understand the implications of accounting policies to financial statements.

III. CAPITAL

The Board shall undertake the following actions in the area of capital, pending resolution of the issues raised in the report:

A. Capital surplus: Fannie Mae will maintain a substantial capital surplus over the required minimum capital requirement.

B. Capital plan: The company will form a joint task force with OFHEO and a member of the Board (Marron) to identify primary strategies which Fannie Mae will employ to protect the existing capital surplus and achieve additional capital surplus over a defined period of time. The plan will be established within 45 days.

C. Limitations on certain corporate actions:

i. The company will protect the existing capital surplus by declining to repurchase, redeem, retire or otherwise acquire any of its shares, including share repurchases (other than with respect to tax withholding under employee benefit plan transactions); to call any preferred stock; to pay preferred stock dividends above stated contractual rates, without the prior written approval of the Director.

ii. Fannie Mae shall submit a written report to the Director after the declaration of any common stock capital dividends and before making the capital distribution. The report shall contain specific information on the amount of the dividend, the rationale for the payment, and the impact on the capital surplus.

D. Monthly reports: Fannie Mae will continue to submit to OFHEO month-end minimum capital reports, no later than 30 days after the end of each month. These shall be reconciled to the general ledger and continue to include the official declaration that is currently part of these reports. Fannie Mae will also submit its most current internal weekly management reports and projections detailing growth and other criteria that impact the maintenance of the additional capital surplus.

IV. ORGANIZATION, STAFFING, INTERNAL CONTROLS

A. The Board shall initiate an independent review of organizational, structural, staffing and control issues addressed in the report, particularly in connection with the CFO, controllers, accounting, audit, financial reporting, business planning and forecasting, modeling, and financial standards functions, including:

i. Lines of reporting
ii. Independence of functions
iii. Segregation of duties
iv. Alignment of functions
v. Roles and responsibilities
vi. Staff qualifications
vii. Key person dependencies
viii. Adequacy of resources

B. Specifically with respect to accounting controls,

i. The Board shall review internal controls relating to accounting as well as staffing, resources, the quality and routine provision of information to senior management and the Board and the effectiveness of the corporate code of conduct and revisions, where necessary, to avoid actions that do not support appropriate corporate goals and legal requirements.

ii. The Board shall review the area of accounting for alteration of reporting lines, independence of a function to evaluate models employed in accounting, the role of external auditor and internal procedures (including strengthening the role of the internal auditor) as well as new positions, where necessary, to remedy any determined weaknesses.

iii. The Board shall direct the separation of the function of business planning and forecasting from the controller's function.

iv. The Board shall direct a separation of modeling and accounting functions.

v. The Board will report to OFHEO on the results of such reviews and actions to be taken.

C. Chief Risk Officer: The Board shall assure the appointment of a chief risk officer, to be independent of other corporate responsibilities. The Committee will consult with OFHEO on the duties of such officer.

D. Internal Auditor Independence: The Board shall assure the independence of the internal auditor, including reporting directly to the Audit Committee and the Board.

E. Compensation: The Board shall review the compensation regime and its relation to strategic plans and their impact on accounting and transaction decisions, and make revisions where necessary to avoid inappropriate incentives.

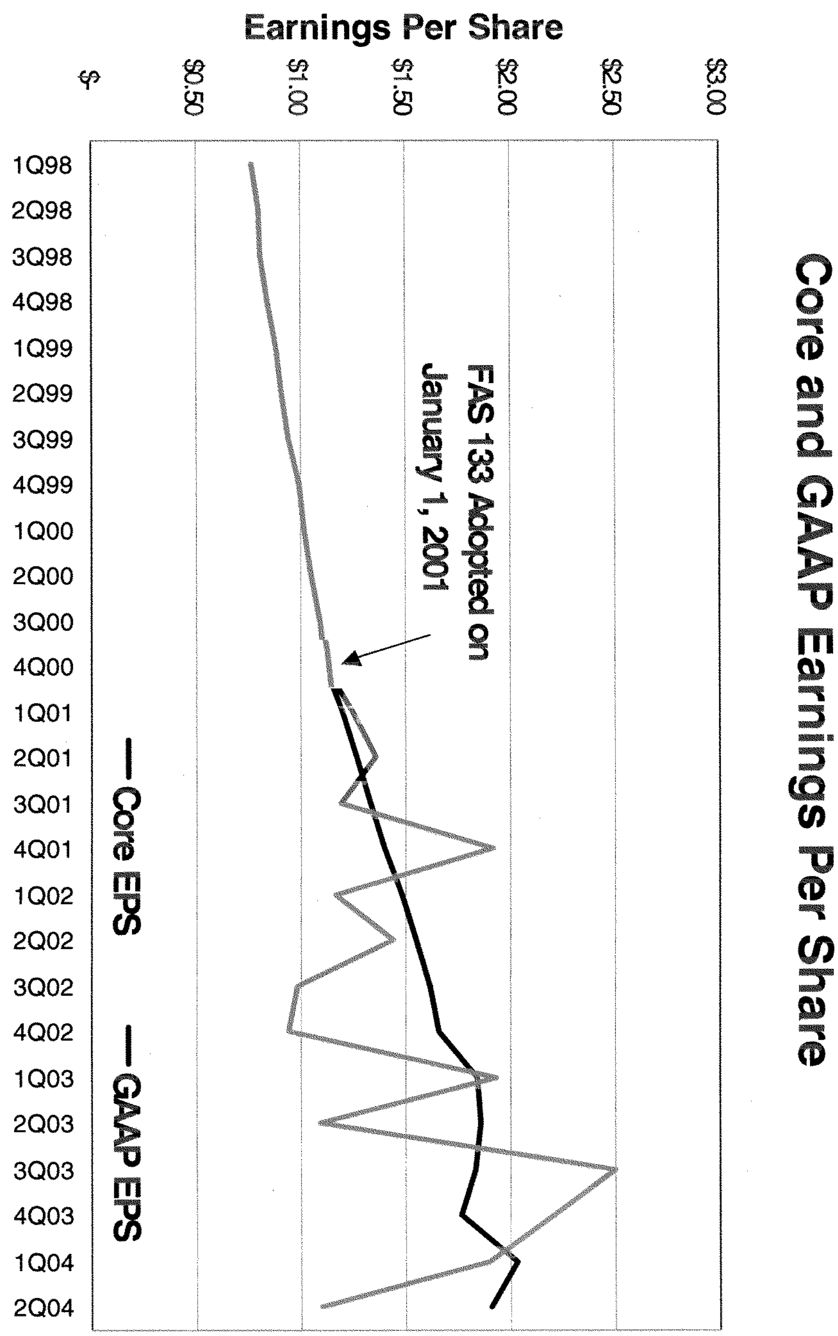
F. The Board will work with management to ensure there is the appropriate responsiveness and professionalism in connection with OFHEO's examination of the company.

V. TRACKING

A. The Committee will monitor and coordinate implementation of this work plan, and meet regularly with OFHEO representatives regarding progress under the plan.

B. The Committee will establish a tracking system, to be provided to OFHEO, to allow the Board and OFHEO to monitor the implementation of and progress under this work plan.

C. The Committee will provide OFHEO a comprehensive written plan concerning the matters in this work plan within 15 days.


Core and GAAP Earnings Per Share
Earnings Per Share
$-
$0.50
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$1.50
$2.00
$2.50
$3.00
1Q98
2Q98
3Q98
4Q98
1Q99
2Q99
3Q99
4Q99
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2Q03
3Q03
4Q03
1Q04
2Q04
FAS 133 Adopted on January 1, 2001
Core EPS
GAAP EPS